

ENTERTAINMENTNOW.COM

It was a chilly December evening, and Mark Dibbs was working late again. As the vice president of financial analysis for EntertainmentNow.com, Dibbs had been charged with analyzing the company's financial results for the past year. EntertainmentNow.com's operating budget for the past year showed an expected net loss per item sold of \$1.94. The company's actual financial results, however, showed a net loss per item sold of \$2.10. Dibbs was expected to explain this variance fully and to make recommendations to senior management based on his analysis.

Background

EntertainmentNow.com offered a comprehensive array of books, music, videos and DVDs, toys, and small electronics on the company's international Web site, EntertainmentNow.com. Considered one of the world's leading Internet retailers of entertainment products, the company focused on providing superior customer service. Similar to Amazon.com, EntertainmentNow.com purchased products from vendors, held the products in inventory, and fulfilled customers' orders directly. EntertainmentNow.com marketed and sold primarily to individual customers. Recently, however, the company had begun serving corporate and institutional customers as well.

During the past few years, EntertainmentNow.com's management had spent a significant amount of capital on the company's technology and infrastructure. Now, the company needed to gain scale in order to generate positive returns on those capital investments. Therefore, EntertainmentNow.com's operating results for the past year were extremely disappointing to management and to the company's stockholders. Furthermore, the increase in net loss per item sold was surprising given that the company's actual sales volume was greater than expected for the year. Dibbs knew he had to be able to explain fully what caused EntertainmentNow.com's increased shortfall.

This case was prepared by Kristy Lilly (MBA '03) and Liz Smith (MBA '04) under the supervision of Professor Mark Haskins. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation. Copyright © 2003 by the University of Virginia Darden School Foundation, Charlottesville, VA. All rights reserved. To order copies, send an e-mail to sales@dardenbusinesspublishing.com. No part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means—electronic, mechanical, photocopying, recording, or otherwise—without the permission of the Darden School Foundation. Rev. 6/09. ◊

Annual Operating Budget

Dibbs looked at EntertainmentNow.com's annual operating budget (**Exhibit 1**). The following information was used in preparing the annual budget:

1. Basing its projections on prior years' data, management expected to have approximately 4 million customer accounts and sell 29.76 million items at an average sales price of \$15.90 each. Cost of goods sold was expected to be 76% of sales revenue.
2. Fulfillment expenses represented costs incurred for warehouses, customer-service centers, and packaging orders for shipment. These costs were budgeted at \$2.50 per item sold. This amount included the estimated cost of opening a new warehouse and distribution center in Phoenix, Arizona, to handle projected growth in the Southwest.
3. Marketing expenses were expected to be \$0.78 per item sold.
4. Technology and content expenses had been high over the last few years, as the company expended significant effort to develop the EntertainmentNow.com Web site. These expenses, however, were expected to remain fairly level over the next few years, as the major work on the site had already been completed. Thus, technology and content expenses were budgeted as a fixed expense of \$23.6 million.
5. Both general and administrative expenses and depreciation and amortization expenses were budgeted as fixed costs.

Actual Results

As a first step in his analysis, Dibbs decided to compile a schedule of budgeted versus actual sales volume and unit prices (**Exhibit 2**). As he knew, total sales volume for the year had increased as compared with budgeted levels. In September, the company had launched a brand-new advertising campaign to boost lagging sales, and sales had rebounded significantly during the last quarter of the year. The advertising campaign was expensive, however, and marketing expenses were raised by \$0.05 per unit for the year. Cost of goods sold averaged 76.5% of actual sales revenue, and fulfillment costs increased to \$2.53 per item owing to cost overruns on the Phoenix distribution center. General and administrative expenses, however, fell by \$250,000 because of lower-than-planned salary increases. In addition, technology and content expenses were \$350,000 higher than expected owing to a significant increase in the number of product offerings, as well as an increase in partnerships with other Web sites, both of which required additional Web-site maintenance. Dibbs knew he had to consider all this information in his variance analysis.

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Required

1. Conceptually, what factors explain the difference between planned and actual results?
2. Prepare a flexible budget for EntertainmentNow.com for the past year, flexing solely on total actual units sold.
3. Quantify the impact on the net loss per item sold of each factor you noted in Question 1.
4. Assume that technology and content, general and administrative, and depreciation and amortization costs are fixed costs that total \$73.7 million annually. Based on EntertainmentNow.com's current sales revenue, cost of goods sold, fulfillment expenses, and marketing, what is the company's break-even sales in units? Is this level of sales realistic? Why or why not?

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Exhibit 1

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Schedule of Planned versus Actual Operating Results

	<u>Plan</u>	<u>Actual</u>
Revenue	\$ 473,280,000	\$ 475,980,000
Cost of goods sold	<u>359,692,800</u>	<u>364,124,700</u>
Gross profit	\$ 113,587,200	\$ 111,855,300
Fulfillment	74,400,000	76,557,800
Marketing	23,212,800	25,115,800
Technology and content	23,600,000	23,950,000
General and administrative	19,000,000	18,750,000
Depreciation/amortization	<u>31,000,000</u>	<u>31,000,000</u>
Loss from operations	\$ <u>(57,625,600)</u>	\$ <u>(63,518,300)</u>
Net loss per item sold	\$ <u>(1.94)</u>	\$ <u>(2.10)</u>

Source: Created by case writer.

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Exhibit 2

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Schedule of Planned versus Actual Volumes and Prices

	<u>Plan Volume</u>	<u>Plan Revenue per Unit</u>	<u>Actual Volume</u>	<u>Actual Revenue per Unit</u>
Books	9,000,000	\$18.00	10,000,000	\$17.50
Music	12,000,000	\$13.00	11,000,000	\$14.00
DVD/Video	7,980,000	\$16.00	8,300,000	\$14.00
Toys	600,000	\$34.00	750,000	\$29.00
Electronics	<u>180,000</u>	\$40.00	<u>210,000</u>	\$43.00
Total	<u>29,760,000</u>		<u>30,260,000</u>	

Source: Created by case writer.