

# *Teaching Case*

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### **ABC Communication, Inc.**

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## ABC COMMUNICATIONS, INC.

Vaughn Jeffs, Vice President of Marketing for ABC Communications, Inc. (ABC) was faced with several concerns as he began preparing plans for the new year. ABC was ending a tremendous year in terms of new distributors, new customers, and revenues, (see Exhibit 1) and Vaughn felt it was extremely important to continue this momentum to insure continued growth. His main concern was how to keep the momentum going in recruiting independent distributors, who were the company's "sales force" while avoiding what seemed to be the inevitable fallout of distributors over time.

### BACKGROUND

The predecessor corporations of ABC Communications, Inc. had been in business since late 1982. This isn't a very long history, but in the long distance telephone industry it's about as old as a company can be. This is because it was in the year 1982 that the government "broke up" AT&T creating the opportunity for competing long distance companies to begin operations. ABC Communications, Inc. started business as a regional company acquiring and servicing customers in the Phoenix, Arizona area.

**Exhibit 1**  
**ABC Communications Financial and Marketing Performance**

	4 yrs ago	3 yrs ago	2 yrs ago	1 yr ago	Past year
Sales	2,000,000	2,750,000	5,125,000	8,265,000	13,426,000
Less pmts to Carriers	1,200,000	1,650,000	3,075,000	4,959,000	8,056,000
Net sales	800,000	1,100,000	2,050,000	3,306,000	5,370,000
Less commissions	500,000	688,000	1,281,000	2,066,000	3,357,000
Contribution	300,000	413,000	769,000	1,240,000	2,014,000
Administration	50,000	60,000	75,000	110,000	160,000
Marketing	100,000	120,000	170,000	235,000	450,000
Net before Interest and Taxes	150,000	233,000	524,000	895,000	1,404,000
Number of customers	500,000	688,000	1,281,000	2,066,000	3,357,000
Number of distributors	100,000	98,000	142,000	172,000	224,000

Five years ago, senior managers decided to operate on a national basis using a multilevel marketing (MLM) or network marketing system of acquiring customers similar to the methods used by Amway, Mary Kay, and Avon. This marketing approach has attracted nationally known leaders in the network marketing industry generating thousands of independent distributors and tens of thousands of customers. The sales organization and customer base expanded rapidly and now represents a powerful force in the long distance telephone industry. Exhibit 1 cites performance data for ABC over the past five-year period.

### **THE APPEAL OF MLM**

The attractiveness of network marketing can be illustrated in the following example. Assume you recruited 3 distributors who, in turn, recruited 3 distributors and this pattern was continued down through all 7 levels of your organization. Also assume each of the distributors had 10 customers. The number of distributors would look like this:

Level	Number of Distributors
1	3
2	9
3	27
4	81
5	243
6	729
7	2187

This would mean you would have 3279 distributors in your downline and if each had 10 customers you would be collecting overrides on the LDU of 32,790 customers. The monthly earnings potential would be significant. Using the national average LDU of \$25 a month and 8.5% overrides on 7 levels, your monthly earnings would be about \$70 thousand per month.

Of course, the fallacy of this example is that not all distributors will recruit 3 more distributors and distributors may not sign up any customers. Also with the heavy fall out of distributors, you may have to recruit 10 distributors to find one who aggressively signs up distributors and customers. In addition, many customers will change services whenever a more attractive offer is presented.

The first MLM or network marketing system was developed in 1941 by Carl Rehnborg, a chemist, who used the system to market his nutritional product. Multi-level marketing is a type of direct selling which is defined as “face-to-face selling away from a fixed retail location” (Peterson and Wortruba, 1996, p. 2). MLM is the type of compensation structure some direct selling organizations employ. In this type of

compensation structure, salespeople (known as distributors) earn income from product they purchase for themselves, sales to other customers, and a portion of the commissions generated by salespeople they have recruited into the organization. These recruited salespeople are known as the distributor's "network" and covers a certain number of "levels" as specified by the company.

This marketing system has been used by many companies spanning a wide variety of industries. For example, household products (Amway), cosmetics (Mary Kay and Avon), long distance (Excel), prepaid legal services ( Pre-Paid Legal Services, Inc.), and weight loss and nutritional products (Herbalife) just to name a few. For the system to work, an individual, usually called an independent distributor, must sign up customers and other distributors who in turn sign up other customers and distributors. Thus a "network" is built by a distributor that covers a certain number of "levels" as specified by the company. A distributor receives commissions or overrides on the products purchased by customers and distributors in these levels or "downline."

These independent distributors are not employees of the company but are in business for themselves and most do this part-time. They receive no fringe benefits directly from the company and the company does not withhold any taxes from their commissions. Each independent distributor is responsible for paying their business expenses and any taxes that may be due on their income.

### **CRITICISMS OF MULTI-LEVEL MARKETING**

Over the years, many criticisms have been cited against multi-level marketing. Some of the standard criticisms are given below.

1. The marketing approach imposes on or takes advantage of family and friends. This criticism is frequently heard because many people involved in multi-level marketing programs approach family and friends as their first source of potential distributors or customers. Sometimes questionable approaches are used such as "I really need to meet with you about an important matter." without revealing what the meeting is really about. This alienates both family and friends because they may later feel deceived about the purpose of the meeting.
2. Some programs require distributors to purchase a substantial amount of products or services to get the "big" discounts or overrides. If the individual is unsuccessful in the program, the products may never be sold and he or she will be stuck with the inventory, or a whole range of services may wind up being paid for on a monthly basis. While some of these products and services may be desired and consumed by the distributor and family members, others may not. Such products could end up in the attic or a rummage sale.

3. Some multi-level programs require a rather large fee to become a distributor and may also require an annual renewal fee to remain a distributor.
4. The excitement or persuasion skills of some recruiters may cause some individuals to be so overwhelmed by the presentation that they postpone or sacrifice other needed expenditures to “get in on the ground level” of the program.
5. In the minds of many, MLM has a negative image.

### **ABC’S BUSINESS MODEL**

It is important to understand that ABC is not an affiliate, nor an agent, nor a marketing arm of the major national carriers who provide the actual long distance transmission services for ABC customers. ABC distributors do not represent the national carriers -- they represent ABC. The customers are customers of ABC, not of national carriers. ABC is a customer of the national carriers and pays the national carriers for the long distance services to ABC customers.

The best way to understand the ABC-national carrier relationship is to understand it in terms of the functions performed by each. ABC acquires customers, provides services, and bills and collects from its customers for long distance services. The major national carriers provide the actual long distance carriage, routing the call to its destination. The carriers also provide ABC with the details of each call including the phone number from which the call originated, destination of the call, time of day the call was placed, and duration of the call. This information is given to ABC on a “billing tape” that ABC simply enters into its computers. Computer software then translates the call detail information into ABC rates, producing a detailed bill that ABC sends to the customer.

The entire thrust of ABC’s business model is to acquire independent distributors who then acquire customers and other distributors who buy and use the products of ABC. These products include long distance service for both customers and distributors and a Data Processing Service and Training Package (DPS-Training) that is an optional purchase made by those ABC distributors who are seriously interested in building a business. The use of products by distributors in a network marketing organization is sometimes referred to as internal consumption and may be a significant source of income for an organization having a large number of distributors.

ABC’s strategy for attracting customers is to offer lower base long distance rates than competitors and give customers a prompt payment discount of 10-17½ percent if the customer pays within 15 days of the billing date. The prompt payment discount depends on the size of the customer’s bill. If the long distance usage (LDU) is \$25 or less, a 10%

discount is given, \$25.01 to \$99.99 bills earn a 12.5% discount, \$100.00 to \$199.99 earns a 15% discount, and bills of \$200 or more earn a 17.5% discount. Since ABC's carriers allow 60 days to pay the carrier, the interest earned on the LDU payments (45 days for prompt payers) generates additional revenues for the company and permits ABC to charge lower LDU rates.

## **THE INDEPENDENT DISTRIBUTOR**

The common denominator of the ABC organization is that everyone is an Independent Distributor (ID). These independent distributors do not work for ABC but are in business for themselves and most do this only part-time. They receive no fringe benefits from the company and the company does not withhold any taxes from their commissions. Each independent distributor is responsible for paying business expenses and any taxes that may be due on their income.

The first function of an Independent Distributor is to acquire customers. If a distributor is interested mainly in signing up personal customers, very little training and virtually no initial investment is required. Simply by completing a distributor agreement, accompanied by a check for \$25, ABC enters the individual's data in the computer, and the new distributor receives a commission on the long distance usage of customers they, personally signed up. Should the distributor later decide not to continue in the business, the company (upon the distributor's written request) would refund the \$25 and assign any customers acquired to the distributor's "upline sponsor," (that distributor who signed them up in the business).

If a distributor desires to build an organization of distributors and earn overrides (commissions) on long distance usage of customers signed up by other distributors in their "downline," (those independent distributors signed up by the distributor) the distributor must purchase a DPS-Training package for an additional \$230. Purchase of this package also entitles the distributor to an intensive training session with an area director. This training is only available to Independent Distributors who purchase the DPS-Training package and the distributor may attend additional training sessions, if desired, at no charge.

## **THE INDEPENDENT DISTRIBUTOR COMPENSATION PLAN**

### **The Basis of Compensation**

ABC has designed its compensation plan to create both immediate and long-term residual income. It's based on the concept of "something for something." Commissions are paid on long distance usage of any customers personally enlisted and on that of sub-distributor's customers down through possibly seven levels of the distributor's organization.

Distributors also earn a \$40 commission on sale of the training package purchased by those recruited by them to become independent distributors. This is a one-time commission and is only collected if the distributor pays \$230 for the training package rather than the \$25 fee. The \$25 fee does not include any material or training. An independent distributor who has built a downline of at least 12 distributors and signed up 10 or more customers may become a Regional Training Director by paying an additional fee of \$125. This fee covers training provided by another company trainer known as a National Training Director. Becoming a trainer produces another source of income since the trainer is paid \$40 by the company for training each new distributor.

### **Long-Distance Usage**

Commissions and bonus payments for the sale of ABC's long distance service are calculated upon the net collected long distance usage revenue of the monthly Dial 1 long distance telephone calls and ABC Card calls made by and billed to the customer. Net collected long distance usage revenue is defined as total per minute usage charges, less discounts, and taxes actually paid by customers to ABC on both domestic and international calls, provided that such payments are postmarked within 60 days from the billing date printed on ABC's bill. The national average LDU is about \$25 per month.

### **Active Customer Defined**

Distributors receive commissions in accordance with the commission schedule set forth in the LDU Commission/Override Structure Chart (Exhibit 2) on active customers who pay their telephone bill. An "active" customer is a Dial 1 customer who has signed up for ABC's long distance service and has been accepted by the company. A "personal active" customer is a Dial 1 customer personally signed up by a distributor, or a Dial 1 customer who is also a second level distributor personally signed up by the distributor. A customer who becomes inactive, is disconnected, or cancelled generates no further commissions or bonuses. If a customer is reinstated and ABC receives payment for long distance usage, then the distributor would once again receive commissions for that customer. A customer may become "inactive" if there is no usage on ABC's service for a period of ninety days.

### **LDU Commission/Override Structure**

Customers personally signed up by an ID are considered first-level customers. Distributors that an ID personally sponsors are first-level distributors and the customers that these distributors personally sign up are second-level customers. An ID may personally sign up an unlimited number of customers on their first level, sponsor an unlimited number of IDs on their second level, and sell DPS-Training packages to an unlimited number of personally sponsored distributors. Downline commissions, overrides, and bonuses are paid through certain levels depending on the ID's production performance. IDs receive a 4% commission on all first-level customers. When IDs personally sign up and maintain five active customers and sell two DPS-Training packages, they receive long distance usage (LDU) commissions and overrides through

five levels of customers. When an ID personally signs up and maintains 10 active customers and sells three DPS-Training packages LDU commissions and overrides are earned through six levels. When an ID signs up 15 active customers and sells four DPS-Training packages, LDU commissions and overrides are paid through seven levels.

An ID who personally signs up and maintains 20 active customers and sells five DPS-Training packages receives additional compensation in the form of a bonus on the LDU of all the customers on the seventh level. This means that the override plus the bonus will equal 4% of the distributor LDU on their seventh level. IDs who sign up and maintain 40 active customers and sell 10 DPS-Training packages, receive another bonus on the LDU of all customers on their seventh level. In this case, the override plus the two bonuses will equal 5% on the distributor LDU on their seventh level and 2.5% on the customer LDU on their seventh level.

The LDU Commission/Override Structure, shown in Exhibit 2, illustrates how these commissions, overrides, and bonuses are paid.

**Exhibit 2**  
**The LDU Commission/Override Structure**

If you have this number of personal active customers	PLUS this number of personal DPS-training package sales	Then you are paid through Level	Distributor LDU Commission override % of	And customer LDU Commission override % of
1	0	1	---	4%
5	2	2	1%	2%
5	2	3	1%	1%
5	2	4	1%	.5%
5	2	5	1%	.5%
10	3	6	2%	.5%
15	4	7	2%	.5%
20	5		+2% bonus	+1% bonus
40 or more	10 or more		+1% bonus	+1% bonus

**DPS-Training Package Commissions/Overrides**

An ID is entitled to receive a \$40 one-time DPS-Training package commission each time they personally sell the DPS-Training package. An ID is expected to help train and manage personally-sponsored IDs, as well as downline IDs, and assist them in obtaining customers and building their organization. In addition to the \$40 DPS-Training package, an ID can also earn downline DPS-Training package overrides. When an ID personally sells 5 DPS-Training packages they qualify to receive a \$5 DPS-Training package override on their seventh level. This means that the DPS-Training package override plus the bonus will equal \$10 paid on DPS-Training packages sold on their seventh level.



The DPS-Training Package Commission/Override Structure (Exhibit 3) explains the number of DPS-Training packages an ID must sell to receive downline DPS-Training package commissions and overrides, and also explains the amount an ID can earn when they meet these requirements.

**Exhibit 3**  
**The DPS-Training Package Commission/Override Structure**

If you have personally sold this total number of DPS-Training packages	Then you are paid through Level	This Commission or Override per package sold
1	2	\$40
2	3	5
2	4	5
2	5	5
3	6	5
4	7	5
5	7	\$5 bonus

Independent Distributors who have not purchased the DPS-Training package should have made this choice because their interest in ABC is primarily in the acquisition of personal customers. The decision to not purchase the package does not affect the amount of LDU and DPS downline commissions.

If a distributor does not purchase the DPS-Training package, that distributor will not receive a \$40 DPS-Training package commission from the first five (5) personal DPS-Training package sales. However, the Distributor would receive credit for the first five DPS-Training package sales. These credits entitle the Distributor to earn LDU and DPS overrides down through seven levels, the same as a Distributor who has purchased the DPS-Training package.

After training, ABC expects a distributor to recruit customers and other distributors in order to build their network. ABC also expects distributors to work with newly recruited distributors to help them build their own network of customers and distributors. While ABC encourages distributors to work their immediate area, they are also permitted to sign up distributors in other parts of the U.S. This creates the potential for a large network covering many states.

**Promotion to Master Distributor**

Through performance, an ID can advance within the ABC network and earn additional benefits and recognition. An ID is promoted to Master Distributor status upon

selling 5 DPS-Training packages and maintaining a personal customer base of 20 or more active customers. As a qualified Master Distributor, an ID is eligible to receive a 1% bonus on the LDU of customers and a 2% bonus on the LDU of distributors on the seventh level.

The company also provides opportunities for additional promotions for distributors who achieve high levels of productivity such as Area Director, Master Area Director and Executive Area Director. These positions require the additional responsibilities of training distributors as well as continuing to recruit personal customers and distributors. They are also asked to keep close contact with distributors to help them be successful in recruiting customers and distributors. Additional compensation may be earned from training fees paid by ABC and training bonuses from other area directors in the downline.

### **Current Issues**

The past year had been hectic but successful. Thousands of distributors have been recruited and thousands of customers signed up. ABC is making waves in the telecommunications industry with its rapid growth and nontraditional marketing program. While many multilevel marketing plans had proven to be flawed and either failed or were legally barred from operations, ABC's carefully developed plan has overcome these flaws. While ABC is nowhere near the size of Amway, with its vast product line and more than 3 million distributors worldwide, they have achieved rapid growth in a very competitive industry still dominated by AT&T.

Vaughn's main concern is the continued need to motivate distributors to recruit new distributors and customers. Since the company does practically no advertising, the personal sales efforts of distributors are the means of acquiring customers. Ultimately, a large customer base could provide the funds for growth and stability in the organization but that can only come by adding distributors and customers. As with all multilevel programs, a lot of distributors drop out (an estimated 80-90%) because they don't like being turned down by potential distributors or customers. Those that do stay must be continually motivated to recruit distributors and customers for the network to grow and achieve financial success. Vaughn feels a need to develop a program to create excitement about the opportunity and help sustain distributor recruitment effort. The company uses weekly emails about meeting opportunities and conference calls as one means of motivation. Also, the company's website frequently posts testimonials of successful distributors and also provides distributors with updates on the company, lists of meetings by state, and how to participate in the conference calls which are done weekly.

While earning potential is high, it takes several months for LDU commissions to generate reasonable amounts. A customer must sign up, switch to a new carrier, and then make long distance calls before revenue accrues to the distributor. This takes two to three months to accomplish and another two months before a distributor sees the commissions. At present, no one knows how to shorten this timeframe and, therefore, a five- to six-month period elapses before a distributor receives LDU commissions. LDU

commissions are the residual income that can build over time to create large distributor earnings. Thus, distributors have to continue to recruit customers and other distributors for a relatively long time before receiving LDU income. Distributors receive commissions (\$40) for recruiting a distributor who purchases the \$230 DPS-Training package within three to four weeks, but this one-time payment is not sufficient to create high income for most distributors. Vaughn believes he needs a motivational program to bridge the gap between signing up customers and generation of LDU commissions, but still is unsure of what type of program to develop.

### **Questions**

1. What are some of the options available to Jeffs to increase the recruiting efforts of current distributors?
2. How important is training of new distributors to the success of the company?
3. What changes, if any, should be made in the current compensation plan to retain current distributors and attract new ones?
4. What recommendations would you make to Jeffs regarding strategies to keep existing distributors motivated?