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H&R Block and “Everyday Financial Services”

In the summer of 2004, Mark Ernst and Jeff Yabuki, the two top executives at H&R Block, looked at a stack of presentations they had seen over the prior months. The presentations outlined new business initiatives that could contribute to sustaining the growth of the 50-year-old market leader in tax preparation services. Some proposals would broaden the firm’s already large client base of 18.7 million Americans. Other proposals, especially the “Everyday Financial Services” plan, would deepen the firm’s relationships with its tax preparation clients. The two men served as the chairman, CEO, and president (Ernst) and the COO (Yabuki) of Block, and they had spent years together at American Express before coming to Block. Block’s tax prep business, while still strong after five decades, faced rising pressure from competition from CPAs, two large branded tax preparers, and more than 50,000 small mom-and-pop nonbranded tax preparation offices. The firm’s profitable refund anticipation loans (RALs), which delivered funds to 4.6 million customers in one to two days, were demanded by consumers but criticized by consumer advocates and seemed to conflict with Block’s mission of being its clients’ “tax and financial partner.”

The Everyday Financial Services (EFS) concept, while still not yet fully developed, was intriguing because it could potentially enable Block to differentiate itself from its rivals, deliver its customers services that they needed and valued, leverage its physical locations and assets, and enhance its brand through improving client loyalty and retention. A large fraction of its customers were low- to moderate-income American families, with 58% of its 16.3 million retail office tax preparation clients earning less than \$30,000 per year. While these families’ financial service needs were substantial, traditional financial service firms had been moving “up market,” leaving these needs to be met by a diffuse set of alternative financial service providers. Block had relationships with these families, a physical presence in their communities, and a trusted brand. In addition, Block facilitated the single largest cash receipt many of these families would receive in a year—their annual tax refund. The EFS proposal, which had evolved out of client research and a series of pilots that the firm had conducted in recent years, would deliver a set of simple financial services to its customers. The proposal had been advanced by a small and passionate team at Block spearheaded by Bernie Wilson, who had been with Ernst and Yabuki at American Express. Wilson had headed tax product development and management before recently moving to lead national community outreach and business development efforts whereby he worked with municipalities and nonprofit organizations on tax-related issues.

While Block could continue with additional pilots, either adding a few sites or services, Ernst and Yabuki were eager to understand the long-term ramifications of the EFS proposal. Was Block well suited to move in this strategic direction? What were the possible benefits for Block? What

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capabilities would they need? What strategic concerns would this raise? Finally, what metrics would Ernst and Yabuki use to determine whether to pull the trigger to go national with EFS?

H&R Block

Beginning in 1954 with a single office in Kansas City, by 2003 Block had grown to be the largest paid tax preparation provider in the world, preparing taxes online and in its offices for 18.7 million clients in the United States and generating \$3.78 billion in revenue through its core tax preparation business and financial services subsidiaries. Henry and Richard Bloch had earlier partnered to form the United Business Company to provide business services to small companies but capitalized on the Internal Revenue Service’s decision in 1955 to discontinue its free tax preparation service by offering tax preparation services in Kansas City. That year, the two brothers changed the name of their company to H&R Block and began expanding operations across the country by opening company offices and entering into franchise agreements.

In 1962, Block went public and in 1969 was listed on the New York Stock Exchange. The company experienced rapid growth through the 1970s driven by expansion into new markets. However, by the early 1980s, growth had slowed, as Block failed to increase the number of returns it prepared through the first half of the decade. (**Exhibit 1** shows the number of returns prepared by Block between 1961 and 2004.) Block found a new driver for client acquisition and revenue growth in the IRS’s adoption of new electronic filing technology in 1986. It allowed tax preparers to electronically submit completed tax returns, dramatically reducing the lag between filing and the receipt of any tax refund due to the filer. In 1987, Block, in partnership with Beneficial Bank (a subsidiary of Household Bank), leveraged that technology to introduce its RAL product. The RAL allowed clients to receive their tax refund much faster than before, with a check issued within two or three days of filing instead of the eight to 10 weeks (if the return was mailed to the IRS and a refund check sent through the mail) if the RAL was not used. This faster turnaround time was accomplished by making a short-term bank loan for the anticipated amount of the federal refund to the RAL purchaser. This loan came to term in an average of 12 days, once the actual refund was received from the IRS by Block. The RAL also enabled clients to defer payment of tax preparation fees by having the fees withheld from their refund before Block disbursed the bank check.

In 1997, under the leadership of then CEO Frank Salizzoni, H&R Block began to expand beyond its core business of tax preparation with the purchase of Option One Mortgage Company. At the same time, Block recruited a new senior management team, largely from American Express. Mark Ernst, 45, joined Block in the fall of 1998 as chief operating officer and executive vice president before being appointed president in the fall of 1999, CEO in January of 2001, and chairman of the board in September of 2002. Prior to his move to Block, Ernst had spent much of his career at American Express, where he focused on brokerage and defined contribution plan services and on introducing American Express’s retail financial services into the Japanese market. Ernst’s MBA training at the University of Chicago in economics and finance accentuated his highly analytical nature, and he worked to move Block toward the use of metrics and rigorous evaluation of its business options and practices.

In 1999, Block continued its acquisitions by purchasing Assurance Mortgage Company, merging it with Option One in 2000.¹ It followed that addition with the purchase of Olde Financial Corporation, a midsized discount brokerage, and RSM McGladrey, a midmarket business services firm, in 1999, building on earlier purchases of smaller firms in both the brokerage and accounting sectors.² However, these acquisitions coincided with downturns in the stock market that adversely affected

the discount brokerage business. In addition, in 2003, Block's core U.S. Tax business saw a declining number of clients, even as the total number of returns filed nationwide grew during that period.

Ernst's appointment marked a transition away from what had been Block's limited engagement with Wall Street. As CEO, Ernst began to schedule analyst calls and to present regularly to investor groups. Large investors also started to take notice of the company, with Berkshire Hathaway acquiring an 8% stake in Block.³ In 2003, analysts used client growth as the primary metric for measuring company success and future profitability, an approach reinforced by the company in its presentations. Analyst reports noted with concern downturns in the numbers of clients served in the 2003 and 2004 tax seasons. Said one, "We continue to be concerned about the increasingly competitive landscape and management's optimism is beginning to sound a bit similar to past seasons."⁴

Block also sought to differentiate itself from its competitors by seeking to provide its clients with financial advice in addition to tax preparation services. Stating that Block's goal was to enhance "client experiences through consistent delivery of valuable services and advice," the company began to offer clients a printed list of financial recommendations and tips, called the Block Advantage, at the close of all tax preparation appointments.⁵ This new undertaking introduced some tension in the organization, principally between the desire to provide advice to clients and the continued sale of products, like the RAL, that many saw as not always being in clients' best interests.

Shortly after Ernst's arrival at Block, Yabuki left Amex, where he had been president and CEO of the tax and business services division, to take over as president of H&R Block International. Yabuki became executive vice president in November of 2000 and COO of Block in April of 2002. Yabuki and Ernst worked together closely to run Block and manage its diverse financial services components. (**Exhibit 2** displays an organizational chart of Block. The EFS team was led by Bernie Wilson, Vice President of Tax Product Development. The group also consisted of David Rose (director of Enterprise Business Strategy), John Thompson (director of Bank Products), and Arijit Roy (manager of Strategy and Analysis).

Block's largest business segments included Option One, the mortgage business; U.S. Tax, the tax preparation arm; and RSM McGladrey, which provided business services and accounting. Combined, these businesses generated \$580 million in income on revenue of \$1.86 billion from U.S. tax preparation, \$1.2 billion from mortgage, and \$720 million from RSM McGladrey and other business components. (**Exhibits 3, 4, and 5** provide additional financial information for Block, and **Exhibit 6** displays data on Block's stock performance from 1988 to 2004. **Exhibit 7** presents selected financial data by Block's business segments.) Block employed approximately 12,000 people, with 7,500 in the U.S. Tax division. That workforce was augmented by roughly 118,000 seasonal tax professionals, 60,000 of whom were employed directly by Block and the remainder by Block franchises, a network of tax preparation offices around the country run by independent owners under agreement with Block.

Tax Preparation Industry Overview

Market Size and Market Share

Approximately 130 million individual federal income tax returns were filed in 2003 in the U.S.⁶ The very large majority of these filers (those not receiving a filing extension) completed their taxes

between January 1 and April 15. Approximately 77% of filers were eligible for a refund due to overpayment or a refundable tax credit of some kind.

Filers not preparing their tax returns themselves (or with the help of family or friends) via pen and paper had the option of purchasing tax preparation assistance through a number of commercial channels. These channels were broadly classifiable as paid large branded retail, CPA, and small mom-and-pop offices, as well as personal computer based. The first channel consisted of three large branded retail tax preparation companies: H&R Block, Jackson Hewitt, and Liberty Tax. Block was by far the largest, serving 16.3 million clients in its office locations in 2003 compared with approximately 3 million clients served by Jackson Hewitt and Liberty Tax combined. The CPA and small branded and unbranded office segment was the largest of the three tax preparation channels, serving approximately 53 million clients annually. While Block did not currently have a significant presence in the CPA market, it did capture some of these filers through its premium offices, which were open year-round and were configured to allow clients to meet in private offices with their tax professional. (Exhibit 8 shows analysts' estimates of the size of the paid retail tax preparation market.) Finally, H&R Block and Intuit essentially shared the personal computer-based market with their products TaxCut and TurboTax. Block held a roughly 30% market share to Intuit's 70% in unit sales of both the online and software tax preparation products (a ratio that had not changed over the past three years). Intuit brought in revenues of \$487 million on operating margins of 23.73%.⁷ In 2003, Block had revenues of \$88 million on operating margins of 10%.⁸

The IRS expected the number of returns filed to increase from 130 million in 2003 to 131 million in 2004, 134 million in 2005, and 143 million in 2010.⁹ Though the number of returns filed in 2004 was expected to increase from 2003, Block saw a decline in both the number of returns it prepared and in its share of the paid retail market during that period. Because many of Block's clients were low income, they were particularly susceptible to shifts in the unemployment rate. Based on this knowledge, Block attributed at least part of the decline in the number of clients served to a higher unemployment rate and longer periods of unemployment.

Over that same period, Jackson Hewitt and Liberty Tax increased the number of returns filed by their offices.¹⁰ However, these increases also reflected the early growth of both businesses—Jackson Hewitt was founded in 1982 and Liberty Tax in 1997, both by John Hewitt, a former Block employee.¹¹ In 2004, Jackson Hewitt prepared approximately 2.53 million returns out of 4,500 locations, increasing the number of returns filed over the prior year by opening additional offices and relying heavily on its RAL product offerings.¹² Liberty Tax, the more recent entrant into the market, prepared 300,000 returns in 2003 and planned to drive growth through a rapid office expansion.¹³ Both companies opened new offices exclusively through franchise agreements, thus lowering their capital costs. Jackson Hewitt and Liberty also drew in clients by giving away free tax return preparation at new outlets. All three leading tax firms were tied, both through John Hewitt and their current executive staffs. Half of Jackson Hewitt's executive officers had worked for Block before changing companies, and five of Liberty's seven executive officers had worked for either Block or Jackson Hewitt.¹⁴ Block executives felt that Jackson Hewitt's and Liberty's successes were due at least in part to their strategy of being a fast second. Liberty Tax purposely opened new offices next to Block locations, and in tax season 2004 Jackson Hewitt rolled out a debit product similar to one previously offered by Block.¹⁵ This fast-second strategy was, according to John Hewitt, also accompanied by "aggressive marketing" undertaken "tenaciously and unconventionally."¹⁶

Economics of the Tax Preparation Business

The paid retail tax preparation sector produced approximately \$13 billion in revenue in 2003 including revenue of \$9.4 billion from CPA and small unbranded offices. Retail tax preparers derived

revenue from two principal sources, tax preparation fees and refund anticipation loan fees. Beginning in the late 1990s, it became much easier for small nonbranded retail tax preparers to offer electronic filing and RALs. In order to submit returns electronically, a tax preparer had to receive official status as an electronic return originator (ERO) from the IRS, and increasingly this had become a simple process. Once established as an ERO, a small tax preparation office could offer RALs with relative ease. Three banks dominated the RAL market: Household Bank, Santa Barbara Bank and Trust (a subsidiary of Pacific Capital Bancorp), and Republic Bank. RAL-originating banks offered the loans through these small offices, compensating the tax preparers on a commission basis. This widespread availability of electronic filing and RAL products led to diminishing differentiation in the retail tax preparation market. Block had increasingly emphasized strong relationships between clients and tax professionals as its primary area of differentiation. However, there had been no discernible increase in client retention since the introduction of this strategy. The rapid growth of branded and nonbranded competitors with their emphasis on convenience and RALs raised concerns that price could soon start to dominate client choice in a way that had not previously occurred in an industry traditionally based on relationships, trust, and brand identification.

Block's U.S. Tax division derived revenue from both company-owned offices and franchises. Franchisees paid Block royalties based on a percentage of fees in exchange for use of the brand name, national marketing support, use of the tax preparation software (TPS), training, and corporate services. While these offices generated profits for Block, the company recently had sought to repurchase a number of large franchises under the terms of their contracts, with the expectation that they could be run more efficiently.

Taking all U.S. Tax operations together, including tax preparation and electronic filing fees in franchise and company-owned offices, RALs, and online and software sales, analysts estimated that Block's revenue from U.S. Tax operations rose 13% in 2004 to \$2.09 billion. While the number of clients served overall was down by about 3% in the retail sector to an estimated 15.8 million, growth in software and online sales compensated slightly to put the overall number of tax preparation clients served at down 0.8% (though the price per return for software and online tax preparation was much lower).¹⁷ Block's fee for tax preparation and electronic filing (but not RALs) at company-owned offices rose 8% over the previous year to a per client average of \$148.90, driving revenue to approximately \$1.51 billion. In addition, Block increased its revenue from franchise royalties by 6.4% to \$174 million. While the number of RALs sold was down 7.5%, in 2004 RAL products produced \$168 million in revenue for Block, up from \$139 million in 2003.¹⁸ This growth was driven by a new agreement between Block and Household Bank, the lender, which allowed Block to share in both the profit and risk of the loans, rather than just receiving a flat payment. Analysts estimated that Block's pretax margin on retail tax preparation services was 28.7%, with a margin on RALs of 75%. One analyst estimated that the stock price/income multiples on the tax preparation segment of the business were 15 compared with five for income generated from RALs.¹⁹ (**Exhibit 9** provides data on the economics of Block's tax preparation business.)

As background to understanding the tax preparation business, it is important to comprehend the dynamic nature of the U.S. Tax Code and the logistical challenges it posed for Block. Each year, the IRS issued 425 changes to the tax code, necessitating updates to Block's tax preparation software and in turn requiring new training for Block's more than 100,000 seasonal employees. In this landscape, the primary costs associated with the business were personnel, marketing, office space, equipment, and IT. However, these relatively straightforward inputs were complicated both by the economics of the tax preparation marketplace and Block's unique position as the largest retail tax preparer in a large, but otherwise unconcentrated, market. With the compensation for professional services making up the largest cost in the industry, economies of scale were not easily attainable.

The costs associated with personnel comprised training expenses and compensation. When Block first entered the business in the mid-1950s, there was a shortage of trained tax preparers. In response, Block offered training to prospective employees and hired graduates of this program for its seasonal positions. This model persisted across time, and Block enrolled 120,000 individuals in its tax preparation classes in 2003, charging an average fee of \$175 each. Of the approximately 100,000 enrolled, approximately 80% were offered a position. However, not all individuals taking these classes did so with the aim of being hired by Block. Rather, by 2004, Block had become the industry’s trainer, with many of the company’s principal competitors sending their employees to receive annual training at Block. While the tax-training schools remained a slightly margin-positive business for Block, the effect was to spare competitors the cost of establishing their own training programs.

Prior to 2004, Block paid tax professionals on commission based on the price of tax preparation, but beginning that year, Block added bonuses based on client retention. While the company had high brand recognition, with 98% of Americans aware of the Block brand, approximately 5 million clients left Block each year (there was a 50% attrition rate for new clients and a 30% attrition rate for returning clients), requiring the company to replace these clients before it could grow. However, 50% of the U.S. population had been to Block in the past, and between 12% and 15% of this pool was composed of former clients who were unlikely to return. Given this situation, the company faced a shrinking pool of individuals receptive to marketing and recruitment. Just to maintain market share, Block spent \$115 million on marketing to recruit 5 million new clients to replace the 5 million it lost each year. In order to increase its market share, Block estimated that it had to spend approximately \$130 per “incremental” client. This expenditure was primarily for marketing and was growing at a compound annual growth rate (CAGR) of 20%–25%. Thus, confronted with an ever-smaller pool of potential clients, Block devoted substantial sums to marketing, while many of the company’s competitors, not facing this restricted pool, were successful in recruiting clients based on the convenient location of their offices and personal recommendations from current customers.

In 2003, Block offered retail tax preparation services from 5,279 company-owned offices and 4,022 franchise offices in the U.S. (generally there was a Block office within 10 miles of every U.S. household). These offices ran total equipment and occupancy costs of \$207.37 million in fiscal year 2003. The company announced plans to expand its office network, working from the belief that Block would benefit by opening new offices in 39% of the metropolitan statistical areas in the country. Block also expanded its operations into Wal-Mart stores, opening 550 locations in 2003 in addition to 700 existing Sears locations. Opening new locations was expected to drive down margins in the short term. But, the new offices would hopefully increase client growth by making Block’s services more easily accessible and by decreasing waiting times for clients during the peak business times of the tax season. These locations would sit dark for much of the year during the off-season, as Block found it more cost effective to lease properties for 12 months a year and leave them vacant except for tax season. It kept open only about 800 company and franchise offices year-round to handle tax concerns by clients outside of the peak demand time.

Recent Experiments

In the 1970s, Block had experimented with offering tax preparation clients a range of services including information about college financial aid, assistance with drawing up a will, and other legal services. Block continued adding to its offerings by providing advice to low-income clients on their eligibility for state and federal assistance programs such as food stamps. Beginning with the introduction of RALs, Block added products and services built around the tax refunds received by 87% of Block clients. In offering RALs, Block took on the role of originating (for its partner Household Bank) short-term loans for the amount of its clients’ expected refunds. Interested clients

would sign up for the service with Block at the time of tax preparation. Block would then examine the "debt indicator" issued by the IRS for the client, basically a report of any offsets for delinquent state or federal taxes, child support, or federal agency debt that would be deducted from the refund. Following approval, the client would return to the Block office in one to two days to pick up a paper check for the amount of the loan. When the actual refund from the IRS was received by Household, fees would be deducted, and the remainder would be used to satisfy the loan. Demand for RALs was concentrated among low-income filers, particularly those with larger refunds, with the average RAL purchaser having a \$3,000 refund. Some at Block believed that, in the years following the introduction of RALs, Block's client demographic had shifted toward the low-income segment.

In 2001, Block introduced "Instant-Money" RALs, which allowed clients to receive their funds in as little as one hour. The process was sped up through the use of a FICO credit check, a measure of creditworthiness computed by a scoring model using credit and demographic data developed by the Fair Isaac Corporation. This credit check was used by Block and Household instead of the IRS debt indicator.²⁰ In 2004, over 1.5 million clients purchased the Instant-Money RAL product. However, its success was limited by what was often an inverse relationship between a client's interest in receiving her refund very quickly and a client's ability to pass a FICO credit check.

Finally, Block also marketed a related product known as a refund anticipation check, or RAC. RACs also appealed to clients interested in speeding up the receipt of their funds. In addition, RACs allowed clients to defer payment of fees to Block until after the refund was received. The product took advantage of IRS practices that resulted in refund payments directly deposited to an account being processed more quickly than refund payments mailed as paper checks. Specifically, RACs allowed clients to receive a refund as a check in the mail just as quickly as if they had their refund directly deposited. Clients authorized Block to have their refunds directly deposited into a temporary bank account. Once the refund deposit was made, Block's bank partner deducted tax preparation and RAC fees from the account and then issued a check to the client for the amount remaining.

Block had been very successful with RALs since their introduction. Though sales were down for tax season 2004, there was still strong demand for the product, and the company sold 4.3 million RALs that year, including 2.8 million from traditional RALs and 1.5 million from instant RALs. RALs generated revenue, but they also generated headaches. In 2003, Block reported a liability and pretax expense of \$43.5 million to cover a legal settlement in Texas challenging its sales practices for RAL products. These lawsuits accompanied opposition from consumer groups and some state and local government officials, with large grass-roots advocacy groups such as the Association of Community Organizations for Reform Now (ACORN) charging Block with engaging in predatory lending.²¹ Several studies released between 2002 and 2004 from well-known policy and research organizations, including the Brookings Institution, found that low-income people spent substantial amounts of their refunds on RAL fees.²² These lawsuits, demonstrations, and studies generated a number of articles in the mainstream press, with pieces in *The Wall Street Journal*, *The New York Times*, and *The Washington Post* reporting on these RAL products.²³ Representative of some of this coverage, *The Boston Globe* editorialized, "Low-income earners are getting a raw deal from tax preparation companies such as H&R Block."²⁴

Given this situation, Ernst observed, "Refund anticipation loans are a product that consumer groups hate and consumers love."²⁵ In the face of these conflicting pressures, Block sought, in Ernst's words, to "find that middle ground where we can offer them [RALs] very responsibly, where we can make sure that consumers know what they're getting into."²⁶ To that end, Block offered side-by-side comparisons of cost and delivery time between IRS mail and direct-deposit options as well as RAL and RAC bank products in tax season 2004, with sales up 30% on the lower-cost RACs.

During this period, Block also began to offer a range of products aimed at helping filers direct their refunds into savings and investment vehicles. Beginning in tax season 2001, Block rolled out nationally an IRA product that clients could open on-site with the direct deposit of their refund. Deposits to Block's Express IRA were kept in an FDIC-insured bank product held by Reserve Funds. Block had opened more than 440,000 Express IRA accounts over the three tax seasons from 2001 to 2004, with clients holding average balances of \$575. Clients paid a \$15 setup fee, in addition to a \$10 annual account maintenance fee and a \$25 account closing fee.²⁷ Express IRAs were not embraced by Block's tax professionals, with only between 25% and 35% of them selling at least one Express IRA. Overall, Block saw a relatively low take-up rate among tax preparation clients, about 1.4%. (**Exhibit 10** compares RALs, Instant RALs, RACs, and the Express IRA.)

In the 2003 tax season, Block piloted a new savings product to accompany the Express IRA product. This new product, a savings account opened at the time of tax preparation, was piloted only in Cleveland. Block opened approximately 400 accounts with average opening balances of \$870, off a take-up rate of 2%. However, the program was implemented on short notice and encountered operational problems. The principal difficulty was with opening accounts. The savings account was built on Block's brokerage platform and, as such, clients were required to pass a credit check through Reserve Funds in order to be able to open an account. However, many of the primarily low-income clients interested in the product encountered problems passing the credit check, depressing take-up. Further, the brokerage platform proved to be an expensive structure for administering the accounts.

Many Block clients relied on check cashers to convert their refunds into cash. In 2000, Block introduced a check-cashing product with the twin goals of capturing a portion of the revenue generated by converting refund checks to cash and lowering the costs of these transactions for its clients in order to draw their business and deepen their relationships with Block.

Block partnered with ACE, the nation's largest check-cashing chain, to place automated check-cashing machines, similar to ATMs but capable of reading Block RAL, RAC, and Instant RAL checks, in a couple of hundred Block offices. In tax season 2004, clients cashed 110,000 refund checks at the machines, representing \$220 million in refunds. Customers were charged 3% of the value of the check in fees, with a cap of \$120.²⁸ However, there were relatively substantial costs associated with the operation of the machines. The units cost \$15,000 each to build and required between \$30,000 and \$40,000 worth of maintenance each year. Further, the machines needed to be loaded with \$220,000 of cash at any given time in order to be able to meet client check-cashing demands, a strain on the working-capital capacity of ACE. Under the agreement between Block and ACE, Block and Household absorbed bad debt arising from RAL checks cashed at the machines, and ACE and Block split losses due to fraud evenly. However, there was tension in the relationship between Block and ACE, and further, given the economics of the machines, ACE found that it could not make the venture profitable. Block was considering whether to offer the machines, perhaps with additional functions, in-house in the future.

In tax season 2004, Block introduced a new product, Debit Plus, in partnership with Bank of America. Debit Plus offered clients in three test markets the ability to receive their federal refunds on a debit card. Block and B of A opened restricted-deposit accounts for participating clients and mailed the debit cards to clients' homes. The IRS made direct deposits into the restricted accounts, which were immediately debited for deferred tax preparation and service fees. Clients were then able to access the funds in the accounts through the debit card platform. There was a one-time fee of \$25 to purchase the card, and additional fees accrued based on a schedule that allowed clients a limited number of free transactions coupled with fees for transactions beyond the monthly limit.²⁹ The average deposit to the stored value card was \$2,350, and clients were able to use their refunds for an average cost of \$35 (the \$25 fee plus \$10 in additional fees for transactions). Overall only 0.58% of all

clients in the test markets elected to purchase the service, though a take-up rate of 7.03% was achieved in offices where Block offered training directly to the tax professionals. In those offices, 29% of tax professionals sold at least one card, as opposed to 15.9% elsewhere.

Everyday Financial Services

Looking for new strategies to drive growth, a team at Block proposed taking the ideas behind Express IRA, the savings pilot, and the check-cashing and debit services further to introduce a new set of financial services that could include check cashing, bill payment, wire transfers, and savings products aimed at Block’s low-income clients. These products would be offered under the name of Everyday Financial Services (EFS) and would provide Block tax clients with year-round financial services, increasing revenue per client and, hopefully, strengthening client loyalty and raising client-retention rates. The EFS team drew its members from Block’s U.S. Tax division, headed since June of 2004 by Timothy Gokey.³⁰

Alternative Financial Services Use and Spending by Block Clients

Block transferred approximately \$29.1 billion in federal refunds to its clients in 2003 for an average refund of over \$2,000. Among Block’s mostly low-income clients this lump-sum payment was likely the largest single check they would receive all year, almost twice the size of a biweekly payroll check that a client making \$30,000 a year would receive. However, the value of these refunds was reduced substantially by an estimated \$1 billion in fees paid by Block clients each year to convert these refunds into currency.

These clients paid such large amounts of their refunds in fees in part because they often lacked relationships with financial institutions such as banks and credit unions. Many were “unbanked” and relied on alternative financial services (AFS) providers such as check cashers, wire-transfer companies, and payday lenders instead of using bank products such as checking accounts to meet their transaction needs. As a consequence, clients paid fees to check cashers to convert their IRS or Block bank partner checks into cash, paid fees to banks and credit unions for use of debit cards and checks related to their refunds, and paid fees to other AFS providers to purchase money orders and send wire transfers to disburse their refunds. Taken together, the use of all these refund-related services cost Block’s unbanked and marginally banked clients between \$400 million and \$500 million, an average of about \$100 each, or 5% of the average refund. However, this \$100 represented only about 10% of the fees these households paid each year to use financial services, with a per client average of approximately \$1,000 in fees yearly.

Block reached approximately 27% of all people in the United States who were unbanked and 11% of all people who were marginally banked, that is, people who might have had accounts with a bank or credit union but who used AFS providers to meet many of their transaction needs. In 2003, Block developed a new three-part framework with these clients in mind, “get more, keep more, save more.” Block had long aspired to help clients maximize the size of their federal refunds, to “get more.” Now, the company was beginning to develop products with the aim of allowing clients to spend less converting their refunds to usable currency, allowing them to “keep more,” and was working on other products that would allow clients to “save more” of their refunds as well.

The Alternative Financial Services Sector

The AFS sector was growing rapidly, with revenues of \$6.4 billion in 2001 and expected revenue growth of approximately 10% annually. This market encompassed a range of financial services with most AFS outlets offering several services, most commonly check cashing, money-order sales, payday loans, and wire transfers. AFS outlets used this broad range of services as well as convenient locations to draw in customers and fought for market share through competitive pricing. While there was a lack of good data on the AFS sector due to the large number of service providers and the small number of public companies, it appeared that check cashing was the primary revenue source for these outlets, followed by money transfers, money orders, and payday lending (described below). AFS providers spent an average of 66% of their sales revenue to meet operating costs, leaving pretax margins on sales of 34%.³¹

Many different organizations cashed checks for unbanked low-income individuals. Banks cashed the largest volume of checks, followed by grocery stores and check cashers.³² There were approximately 10,000 check-cashing outlets in the U.S. in 2003, processing 180 million checks for \$1.9 billion in fees.³³ The largest player, ACE, had a 12% market share and, even given all large chains including Money Mart, USA Checks Cashed, Mr. Payroll, Cash America, Dollar Financial, and Check into Cash, the business was relatively unconcentrated.³⁴ Among larger chains, average fees ranged from 2.2% at ACE to 3.3% charged by Dollar Financial, or \$45-\$65 of a \$2,000 refund check.³⁵ However, this market was in flux, with banks increasingly reluctant to cash checks for noncustomers and Wal-Mart entering the industry, introducing the possibility of lower fees and a price-based competitive struggle.

The wire-transfer market was much more concentrated, with Western Union holding a 75% market share and Money Gram a 15% share. Revenues in 2001 were about \$1 billion with margins around 33%. The international remittance market was expected to expand substantially, with growth projected at 15% annually.

The majority of money orders were sold by the two largest players in the market, Travelers Express and First Data, which together accounted for half of all money-order sales. Viad had owned both Travelers Express and Money Gram but spun both companies off as Money Gram International in 2004. The U.S. Postal Service sold a large amount of money orders as well, followed by check-cashing outlets, which held a 22% market share and had sales of \$20 billion in face value. Overall, total revenues from money orders were a little over \$1 billion in 2003, with an expected CAGR of 5.1%. Money orders were priced at between \$0.40 and \$1.10 at nonbank outlets.

In addition to these three most common services provided by AFS outlets, low-income customers sought a range of other low-cost services. These included bill payment, ATM access, and unsecured credit. The bill-payment market grew rapidly, with 17.6% growth in 2000.³⁶ In that year 2.6 billion direct payments were made with a value of \$1.6 trillion.³⁷ Low-income individuals also turned to ATMs for transaction and banking services. By 2001, ATMs had become ubiquitous, with 324,000 machines nationwide, 263 million cards, and 1.36 billion transactions.³⁸ During this time, a number of companies began testing multifunctional ATMs. 7-Eleven introduced machines capable of cashing checks, issuing money orders, and transferring funds and planned to increase the availability of these machines by introducing them in 2,500 stores in 2003.³⁹

Payday lending was the principal type of unsecured credit offered to marginally banked low-income individuals. The loans were short term, generally with a two-week maturity. When first offered in the early 1990s, borrowers would leave a postdated check with the lender for the value of the loan. The lender would either deposit the check when the loan came due or receive a cash payment from the borrower. This system had been updated so that borrowers could authorize the

lender to debit their accounts when the loan came due.⁴⁰ By 2000, payday lending revenue topped \$2 billion on a volume of 65 million loans.⁴¹ Banks also began to offer the equivalent of payday loans in the form of overdraft protection, wherein account holders who overdrew their accounts were automatically offered short-term loans for the amount of the overwithdrawal. The payday loan industry, led by EZCorp and World Acceptance, came under enormous criticism for fees that were, on average, \$15–\$17 per loan, creating effective APRs that reached above 390%.⁴² Consumer advocates also criticized payday lenders for trapping borrowers in a cycle of debt wherein borrowers paid an additional fee for every two weeks they decided to extend the loan, potentially paying more than \$1,000 in charges on one of these relatively small initial loans.⁴³ However, despite these criticisms, the industry's expected growth rate outpaced that of the check-cashing, money-order, or wire-transfer AFS sectors.⁴⁴ (**Exhibit 11** presents data on the economics of the AFS sector. **Exhibit 12** displays key financial information for Block's tax and AFS competitors.)

Outside of AFS providers, low-income consumers also required savings products and notary public services. While many unbanked individuals had few places at which to save, several banks and credit unions had offered products targeted at low-income savers, such as Union Bank of California, Banco Popular, and Bethex Federal Credit Union, as well as other community development banks and credit unions.⁴⁵ In addition, government-funded programs such as the Treasury Department's First Accounts initiative and a program of matched savings accounts funded under the Assets for Independence Act had given a handful of low-income individuals some avenues through which to build savings.⁴⁶

Notary publics served an important role within low-income communities. While the market was quite fragmented, there were upwards of 40,000 outlets around the country. The notary public played a particularly important role in low-income Hispanic communities because of the wider range of services offered there, particularly regarding immigration issues, and the elevated status of a "notario" in Latin America.

The EFS Concept

Considering both the demographic profile of Block's current client base and the competitive landscape of the AFS sector, the EFS team saw an opening in which Block could thrive through increased revenues and client retention. They proposed offering year-round financial services to Block tax preparation clients. These financial services would be based out of Block offices that would be open year-round instead of just for the four-month-long tax season. These EFS offices would be created by retrofitting approximately 1,550 of the 4,000 existing Block "A" offices, largely urban offices located within five minutes of public transportation.

Under the proposal, Block would offer a range of products including check cashing, wire transfers, money-order sales, bill payment, basic savings products, and notary public services out of these locations and in connection with tax preparation. The company planned to be able to offer these products at significantly lower costs, as much as 50% lower, than AFS providers were able to. These pricing reductions would be realized through comparatively lower acquisition costs, as Block could draw on its existing customer base, more extensive utilization of existing physical assets, and a lower capital cost (due to its larger size and better rating than its AFS competitors). Further, by cashing only government and refund checks, Block hoped to reduce its risk and cut its bad-debt costs. Block also planned to offer the majority of these transaction and savings products on a plastic card platform that could be used at ATMs and at self-service machines in Block offices.

The team expected that EFS would drive revenue growth for Block in two ways. First, by offering a range of financial service products that Block customers currently bought from other vendors, Block

could capture a portion of this substantial revenue in-house, increasing revenue per client. Second, client retention could be improved by deepening the relationship between Block and its clients, expanding the clients' association with Block beyond the once-a-year tax preparation event.

Block customers expressed strong interest in the EFS products, with 47% of clients surveyed reporting interest in purchasing check-cashing services for their refund and 39% expressing interest in purchasing check-cashing services year-round. Clients also expressed interest in bill payment, wire transfers, notary public services, and ATM access. Revenue projections indicated that every EFS center could draw between 1,275 and 1,410 clients making a yearly average of 12 visits each to produce between \$197,000 and \$267,000 in transactional revenue, with an EBITA margin of 20% to 32%. It also appeared that client retention could be affected positively by selling additional products to clients. Retention had been improved by as much as 10 points among those Block clients purchasing an Express IRA, and market research indicated that among Block customers considering seeking tax preparation services elsewhere, 29% reported that they would definitely or probably purchase products through EFS instead.

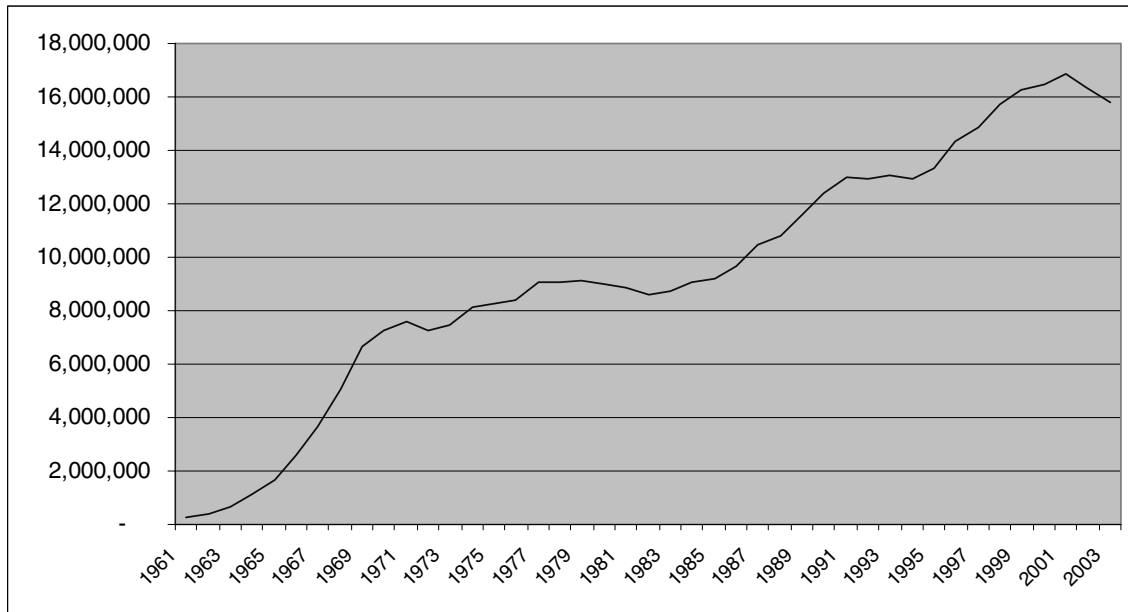
However, it was largely unknown to what extent offering a suite of EFS products might also harm Block. While there was little evidence from market research that offering products such as check cashing and money transfer would have any negative effect on higher-income Block clients' perceptions of the company, many at the firm's Kansas City headquarters worried about potential damage to the brand. Further, there was concern that if the EFS products were perceived negatively in the marketplace, they might not only fail to generate revenue but could also undercut Block's brand by generating negative publicity.

With this information in hand, Block planned to pilot two versions of the EFS concept in tax season 2005. In 10 cities, Block offices would offer clients the ability to cash checks, make deposits, purchase money orders, and set up automatic payroll deposit. This version of EFS was relatively broad, with a suite of traditional AFS services offered through Block offices. The company was also planning to pilot a more limited set of product offerings in a much larger number of offices. Block planned to sell a product that would allow clients in several thousand offices to have their refunds put on a reloadable debit card in order to avoid check-cashing fees. Finally, in some sense, the previously introduced Express IRA constituted a third version of EFS, with clients at all Block offices able to purchase additional financial products through Block at the time of tax preparation.

Strategic Directions and Decisions

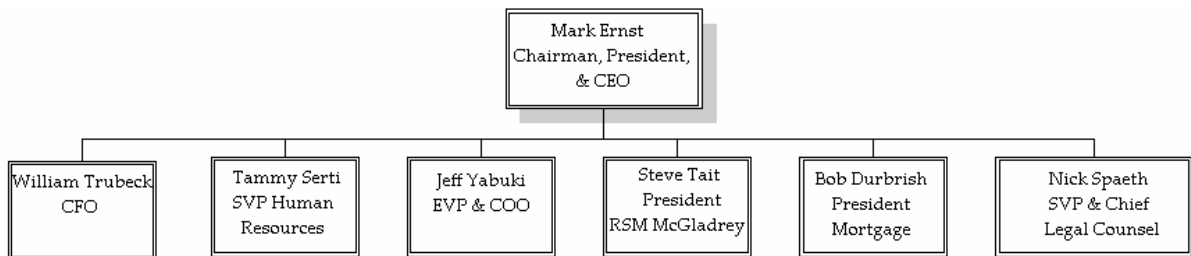
The EFS proposal was still evolving. At a minimum, it seemed clear that Block would continue to offer some financial services products in connection with tax preparation including Express IRA and Debit Plus. But Block's top executives faced a critical strategic decision: whether to offer a wider set of products year-round. The exact mix of services that would be offered, the sites that would stay open, the staffing for the sites, and even regulatory clearances would all need to be clarified. Block could attempt to create its own set of products and services, or it could choose to partner with other firms. It could offer EFS services under the Block brand, or it could market the EFS services under a new brand tailored to the low-income segment. If it succeeded, Block might not only find new ways to create revenues and profits but also better serve its loyal customer base, a group of households that much of the financial service world seemed happy to ignore. Such success could have broad implications, democratizing financial services on a large scale and enhancing Block's reputation. This "win-win" would be a tremendous success. But for every "win-win" story were a series of less memorable tales, and Ernst and Yabuki needed to think about how the EFS plan would be received in the marketplace, within H&R Block, and by the firm's shareholders.

Exhibit 1 Tax Returns Prepared by H&R Block Paid Retail, 1961–2004



Source: Company documents.

Exhibit 2 Organizational Chart of H&R Block



Source: Company documents.

Exhibit 3 H&R Block Income Statements (\$ millions)

| Tax Year April 30 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|--|----------------------|----------------------|-----------|----------------------|-----------|-----------|
| Total Revenue | \$1,270.0 | \$1,644.7 | \$2,425.7 | \$2,981.3 | \$3,317.7 | \$3,779.8 |
| Operating Expenses Total | \$959.6 | \$1,220.4 | \$1,868.6 | \$2,273.7 | \$2,486.2 | \$2,706.9 |
| Employee Compensation and Benefits | \$484.0 | \$610.9 | \$963.5 | \$1,192.3 | \$1,308.7 | \$1,401.4 |
| Occupancy and Equipment | \$158.0 | \$182.7 | \$253.2 | \$283.2 | \$305.4 | \$346.0 |
| Depreciation and Amortization | \$55.0 | \$74.6 | \$147.2 | \$205.6 | \$155.4 | \$161.8 |
| Marketing and Advertising | \$71.6 | \$90.1 | \$105.4 | \$111.0 | \$155.7 | \$150.2 |
| Other | \$191.1 | \$262.1 | \$399.3 | \$481.7 | \$561.0 | \$647.5 |
| Operating Income or Loss | \$310.4 | \$424.3 | \$557.1 | \$707.6 | \$831.6 | \$1,072.9 |
| Income from Continuing Operations | | | | | | |
| Earnings before Interest and Taxes | \$335.3 | \$452.8 | \$567.3 | \$715.6 | \$833.0 | \$1,079.7 |
| Net Interest Expense | -\$38.9 | -\$69.3 | -\$155.0 | -\$242.6 | -\$116.1 | -\$92.6 |
| Income Tax Expense | -\$112.6 | -\$145.7 | -\$160.4 | -\$196.3 | -\$282.4 | -\$407.0 |
| Net Income from Continuing Ops | \$183.8 ^a | \$237.8 ^b | \$251.9 | \$276.7 ^c | \$434.4 | \$580.1 |

Source: Company documents.

^a Net income does not reflect the loss of \$23.525 or the gain of \$231.867 from discontinued operations.

^b Net income does not reflect the loss of \$1.490 from discontinued operations or a loss of \$20.939 from the sale of discontinued operations.

^c Net income does not reflect a loss of \$4.414 arising from a change in accounting principle for derivatives and hedging activities relating to the mortgage business.

Exhibit 4 H&R Block Cash Flows (\$ millions, except P/E)

| Tax Year April 30 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|-----------|------------|------------|-----------|-----------|-----------|
| Cash from Operating Activities | \$195.2 | \$232.8 | \$453.00 | \$248.4 | \$741.4 | \$690.8 |
| Cash from Investing Activities | | | | | | |
| Capital Expenditures | -\$46.3 | -\$78.8 | -\$145.8 | -\$92.4 | -\$111.8 | -\$150.9 |
| Investments ^a | \$478.3 | \$481.9 | \$265.8 | \$367.1 | \$91.3 | \$282.7 |
| Other | -\$307.2 | -\$152.1 | -\$970.0 | -\$18.4 | -\$38.5 | -\$6.5 |
| Total Cash from Investing Activities | \$124.8 | \$251.0 | -\$849.9 | \$254.8 | -\$59.0 | \$125.3 |
| Cash from Financing Activities | | | | | | |
| Dividends Paid | -\$83.6 | -\$95.0 | -\$105.5 | -\$108.4 | -\$115.7 | -\$125.9 |
| Sale (Purchase) of Stock | \$40.5 | -\$682.6 | -\$17.4 | -\$203.3 | -\$267.7 | -\$191.2 |
| Net Borrowings | \$166.9 | -\$412.9 | \$702.9 | -\$352.5 | -\$50.6 | -\$57.5 |
| Other | \$0.0 | -\$0.7 | -\$29.6 | \$2.0 | \$0.1 | -\$2.3 |
| Total Cash from Financing Activities | \$123.8 | -\$1,191.2 | \$550.4 | -\$662.2 | -\$433.9 | -\$377.0 |
| Market Cap ^b | \$2,407.1 | \$4,701.9 | \$3,900.20 | \$5,049.0 | \$7,266.8 | \$6,936.2 |
| P/E High ^c | 13 | 24 | 23 | 18 | 22 | 17 |
| P/E Low | 8 | 17 | 15 | 9 | 11 | 9 |

Source: Company documents, Hoovers Online, OneSource Global Business Browser, and Thomson Research.

^a Investments are composed of purchases of available-for-sale securities, maturities of available-for-sale securities, and sales of available-for-sale securities.

^b Market capitalization is calculated as the number of shares outstanding as of April 30 of each year times the closing price of an H&R Block share on April 30 of that same year.

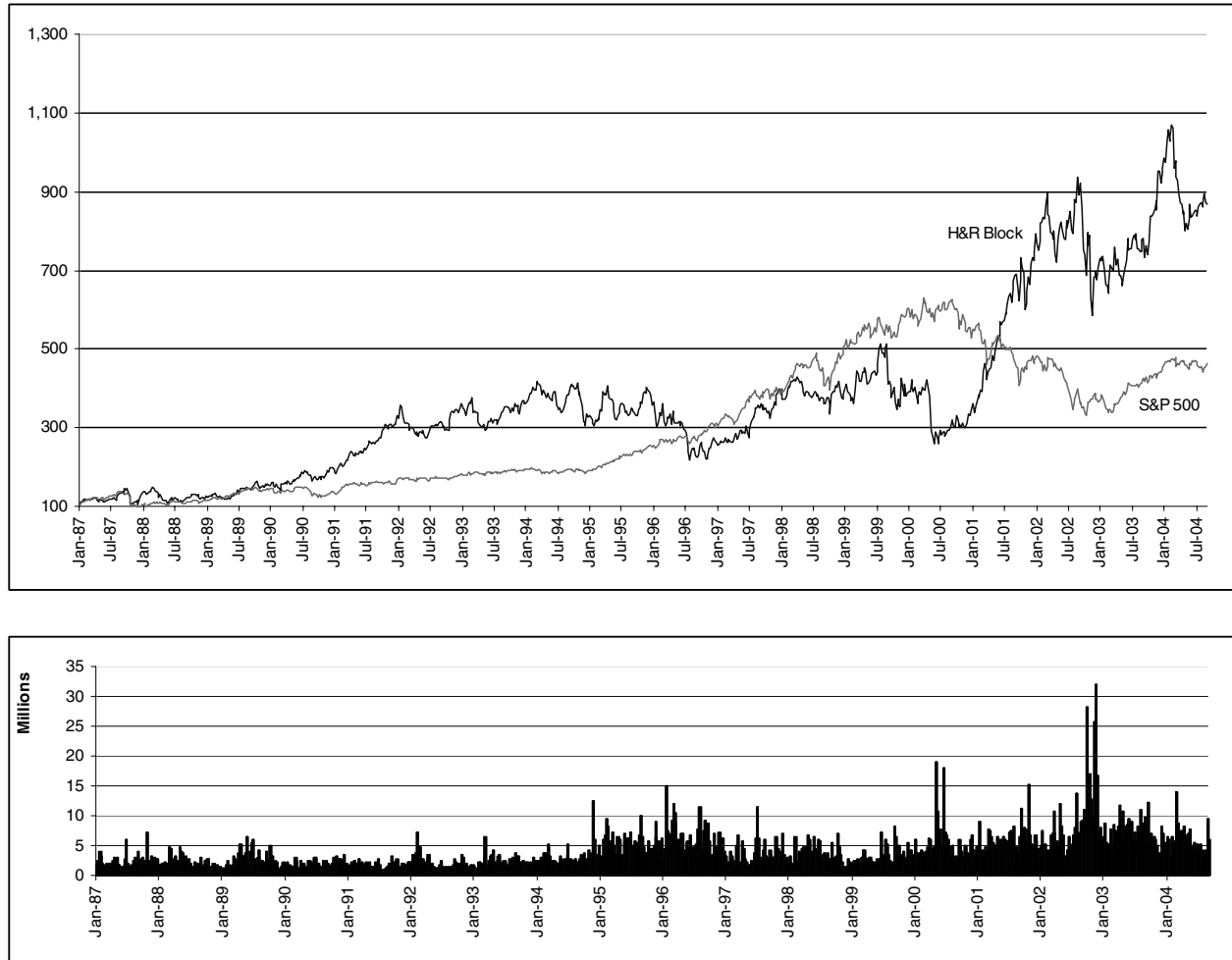
^c P/E high and P/E low are calculated as the high and low share price for the year divided by earnings per share from total operations.

Exhibit 5 H&R Block Balance Sheets (\$ millions)

| Tax Year April 30 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|--------------------------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| Assets | | | | | | |
| Current Assets | | | | | | |
| Cash and Short-Term Investments | \$1,247.0 | \$250.1 | \$442.3 | \$326.2 | \$616.7 | \$1,337.5 |
| Net Receivables | \$793.2 | \$743.3 | \$3,292.1 | \$1,676.1 | \$1,212.9 | \$920.2 |
| Other Current Assets | \$103.0 | \$94.0 | \$145.7 | \$260.9 | \$415.6 | \$489.7 |
| Total Current Assets | \$2,143.3 | \$1,087.4 | \$3,880.1 | \$2,263.3 | \$2,245.1 | \$2,747.4 |
| Long-Term Investments | \$289.1 | \$170.5 | \$239.3 | \$270.2 | \$462.5 | \$380.6 |
| Property Plant and Equipment | \$77.3 | \$114.2 | \$299.5 | \$288.8 | \$286.5 | \$288.6 |
| Goodwill/ Intangible Assets | \$288.6 | \$405.5 | \$1,095.1 | \$1,051.8 | \$1,106.9 | \$1,056.1 |
| Other Assets | \$105.8 | \$132.5 | \$198.9 | \$239.6 | \$129.7 | \$131.2 |
| Total Assets | \$2,904.1 | \$1,910.2 | \$5,712.9 | \$4,113.7 | \$4,230.8 | \$4,603.9 |
| Liabilities | | | | | | |
| Current Liabilities | | | | | | |
| Accounts Payable | \$1,276.9 | \$549.1 | \$3,466.0 | \$1,928.7 | \$1,820.0 | \$1,841.5 |
| Short-Term Portion of Long-Term Debt | | \$4.7 | \$68.0 | \$51.8 | \$59.7 | \$55.7 |
| Total Current Liabilities | \$1,276.9 | \$553.8 | \$3,534.0 | \$1,980.5 | \$1,879.7 | \$1,897.2 |
| Long-Term Debt | \$249.7 | \$249.7 | \$872.4 | \$871.0 | \$868.4 | \$822.3 |
| Other Liabilities | \$35.9 | \$44.6 | \$87.9 | \$88.5 | \$113.3 | \$220.7 |
| Total Liabilities | \$1,562.5 | \$848.2 | \$4,494.3 | \$2,940.0 | \$2,861.4 | \$2,940.2 |
| Total Stockholder Equity | \$1,341.6 | \$1,062.0 | \$1,218.6 | \$1,173.7 | \$1,369.4 | \$1,663.7 |

Source: Company documents.

Exhibit 6 H&R Block Stock Performance, Compared to the S&P 500 Index, 1987–2004



Source: Thomson Datastream.

Exhibit 7 H&R Block Operations by Business Segment (\$ millions)

| Tax Year April 30 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|--|---------------------------|---------------------------|------------------|------------------|------------------|----------------------------|
| Revenues | | | | | | |
| U.S. Tax Operations | \$1,047.3 | \$1,258.3 | \$1,397.5 | \$1,622.6 | \$1,830.8 | \$1,860.0 |
| Mortgage Operations | — | — | \$355.4 | \$415.8 | \$734.9 | \$1,200.4 |
| Business Services | — | \$47.3 | \$319.9 | \$386.2 | \$416.9 | \$434.1 |
| Investment Services | \$135.8 | \$259.9 | \$268.4 | \$472.4 | \$250.7 | \$200.8 |
| International Tax Operations | \$81.8 | \$74.7 | \$79.8 | \$78.5 | \$78.7 | \$85.1 |
| Corporate Operations | \$5.1 | \$4.4 | \$4.7 | \$5.8 | \$5.8 | -\$0.7 |
| Total Revenues | \$1,270.0 | \$1,644.7 | \$2,425.7 | \$2,981.3 | \$3,317.7 | \$3,779.8 |
| Income Before Taxes | | | | | | |
| U.S. Tax Operations | \$252.2 | \$314.1 | \$320.0 | \$434.1 | \$533.5 | \$547.1 |
| Mortgage Operations | — | — | \$88.6 | \$138.0 | \$339.4 | \$694.0 |
| Business Services | — | \$7.1 | \$17.1 | \$16.0 | \$22.7 | -\$14.1 |
| Investment Services | \$29.2 | \$61.1 | \$41.2 | \$9.3 | -\$54.9 | -\$128.3 |
| International Tax Operations | \$11.9 | \$2.5 | \$4.9 | \$6.0 | \$7.1 | \$10.5 |
| Corporate Operations | \$3.1 | -\$1.3 | -\$59.5 | -\$130.3 | -\$131.0 | -\$122.0 |
| Total Income Before Taxes | \$296.4 | \$383.5 | \$412.3 | \$473.1 | \$716.8 | \$987.1 |
| Depreciation and Amortization | | | | | | |
| U.S. Tax Operations | \$37.3 | \$49.4 | \$66.5 | \$69.9 | \$59.3 | \$58.1 |
| Mortgage Operations | — | — | \$20.3 | \$22.8 | \$14.8 | \$21.7 |
| Business Services | — | \$3.3 | \$29.1 | \$38.8 | \$21.4 | \$23.1 |
| Investment Services | \$12.7 | \$16.0 | \$25.7 | \$67.3 | \$52.2 | \$54.0 |
| International Tax Operations | \$4.5 | \$5.7 | \$5.5 | \$5.2 | \$4.9 | \$3.4 |
| Corporate Operations | \$0.4 | \$0.2 | \$0.2 | \$1.4 | \$2.9 | \$1.5 |
| Total Depreciation and Amortization | \$55.0 | \$74.6 | \$147.2 | \$205.6 | \$155.4 | \$161.8^a |
| Capital Expenditure | | | | | | |
| U.S. Tax Operations | \$36.5 | \$63.4 | \$95.3 | \$42.3 | \$58.7 | \$62.4 |
| Mortgage Operations | — | — | \$15.9 | \$34.4 | \$23.1 | \$38.2 |
| Business Services | — | \$1.1 | \$9.1 | \$9.8 | \$10.7 | \$15.2 |
| Investment Services | \$4.7 | \$8.1 | \$21.6 | \$3.6 | \$10.3 | \$15.6 |
| International Tax Operations | — | \$7.7 | \$3.6 | \$2.3 | \$4.4 | \$3.1 |
| Corporate Operations | \$1.5 | \$0.1 | \$0.2 | \$0.1 | \$4.7 | \$16.4 |
| Total Capital Expenditure | \$49.8^b | \$80.4^b | \$145.8 | \$92.4 | \$111.8 | \$150.9 |
| Identifiable Assets | | | | | | |
| U.S. Tax Operations | \$200.2 | \$268.7 | \$348.7 | \$266.4 | \$269.5 | \$281.3 |
| Mortgage Operations | — | — | \$685.3 | \$938.4 | \$1,233.9 | \$1,156.8 |
| Business Services | — | \$146.3 | \$517.1 | \$576.0 | \$665.0 | \$674.6 |
| Investment Services | \$829.5 | \$1,038.9 | \$3,678.6 | \$2,011.5 | \$1,656.5 | \$1,489.3 |
| International Tax Operations | \$48.4 | \$55.7 | \$59.7 | \$42.6 | \$47.8 | \$33.1 |
| Corporate Operations | \$1,623.6 | \$400.7 | \$423.4 | \$278.8 | \$358.1 | \$968.7 |
| Discontinued Credit Card Operations | \$202.4 | — | — | — | — | — |
| Total Assets | \$2,904.1 | \$1,910.2 | \$5,712.9 | \$4,113.7 | \$4,230.8 | \$4,603.9 |

Source: Company documents.

^a Does not include a \$35.78 million goodwill impairment.

^b Includes property roll forward for 1998 and 1999, making total capital expenditure for those years not equal to expenditure on property, plant, and equipment as reported in Exhibit 4.

Exhibit 8 Estimated Number of Returns by Tax Preparation Channel by Year (numbers in millions)

| Tax Year April 30 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|-------|-------|-------|-------|-------|
| Number of Returns Filed | 125.2 | 127.6 | 129.8 | 130.9 | 130.7 |
| Returns Prepared by Paid Retail (including CPA) | 64.0 | 64.4 | 66.9 | 72.4 | 72.4 |
| Block Retail | 15.8 | 16.3 | 16.4 | 16.9 | 16.3 |
| Jackson Hewitt Retail | — | 1.4 | 1.8 | 2.2 | 2.5 |
| Liberty Tax Retail | — | — | — | 0.2 | 0.3 |
| CPA and Others | 48.2 | 46.8 | 48.7 | 53.1 | 53.2 |

Source: Chris P. Gutek and Sharat Shroff, "H&R Block: Examining Long Term Growth and Margins," Morgan Stanley, May 24, 2004, available from The Investext Group, <http://www.investext.com>, accessed July 2, 2004, and the Internal Revenue Service.

Exhibit 9 Economics of H&R Block U.S. Tax Division (numbers in millions except offices and margins)

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|--|-------------------|-----------|----------|----------|----------|
| Revenue | | | | | |
| <i>All U.S. Tax</i> | | | | | |
| Returns Prepared | 15.8 | 16.3 | 16.4 | 16.9 | 16.3 |
| Tax preparation + electronic filing fees | \$1,534.2 | \$1,716.9 | \$1885.1 | \$2089.2 | \$2156.9 |
| Estimated Margin | 23% | 23.2% | 26.7% | 27.8% | 28.7% |
| <i>Company-Owned Offices</i> | | | | | |
| Returns Prepared | 9.8 | 10.2 | 10.3 | 10.4 | 10.0 |
| Revenue | \$989.4 | \$1108.7 | \$1237.6 | \$1364.7 | \$1378.1 |
| Number of Offices | 5162 ^a | 5162 | 5060 | 5017 | 5279 |
| <i>Franchise Offices</i> | | | | | |
| Returns Prepared | 6.0 | 6.0 | 6.2 | 6.5 | 6.4 |
| Royalties | \$114.9 | \$128.9 | \$140.1 | \$154.8 | \$163.5 |
| Number of Offices | 4048 ^a | 4048 | 4012 | 3998 | 4022 |
| <i>Refund Anticipation Loans</i> | | | | | |
| Number of RALs | 2.8 | 4.8 | 4.0 | 4.7 | 4.6 |
| RAL Revenue | \$90.1 | \$89.8 | \$133.8 | \$160 | \$139.1 |
| Estimated Margin | | 51% | 51% | 61% | 75% |
| <i>Software Revenue</i> | \$33.5 | \$26.2 | \$44.1 | \$54.3 | \$61.4 |
| OTP Revenue | - | - | \$6.8 | \$14.6 | \$26.3 |
| Estimated Margin Software/OTP | -1% | -60% | -18% | -19% | 10% |
| Other | \$30.5 | \$44.0 | \$60.2 | \$82.4 | \$91.7 |
| Operating Expenses | | | | | |
| Compensation and Benefits | \$472.4 | \$518.0 | \$562.0 | \$598.4 | \$577.5 |
| Occupancy/Equipment | \$154.1 | \$173.7 | \$172.6 | \$187.0 | \$207.4 |
| Marketing/Advertising ^b | \$90.1 | \$105.4 | \$81.2 | \$127.5 | \$114.6 |
| Other | \$246.1 | \$385.9 | \$393.7 | \$412.4 | \$437.9 |

Source: Company documents and Chris P. Gutek and Sharat Shroff, "H&R Block, F4Q04 Results: Rising Challenges," Morgan Stanley, June 10, 2004, and "H&R Block, F4Q03 Preview: Mortgage May Have Blowout Results," June 1, 2003, available from The Investext Group, <http://www.investext.com>, accessed July 2, 2004.

^a H&R Block did not report the number of U.S. offices that were company owned and franchise owned in 1999. However, the total number of U.S. offices were reported as 9,210, the same aggregate number as in 2000. Here, the same ratio of franchise to company offices is assumed.

^b The marketing and advertising expenditures listed for U.S. Tax for 1999 and 2000 are the same as total H&R Block marketing and advertising expenditures for those years. U.S. Tax marketing made up the large majority of total marketing and advertising expenditures until 2001 when they were first broken out by unit. The marketing and advertising expenditures for 2001, 2002, and 2003 include expenditures for marketing TaxCut, Block's software product, of \$20.9 million, \$28.0 million, and \$24.0 million, respectively. The costs are supplementary to the total U.S. Tax division expenditures used to calculate income before taxes for the U.S. Tax division in **Exhibit 7**.

Exhibit 10 H&R Block Financial Products

| | Year Introduced | Average Fee to Customer | Number Sold 2003 |
|--|-----------------|--------------------------|------------------|
| Refund Anticipation Loans ^a | 1987 | \$80 | 4.6 million |
| Refund Anticipation Check | 1991 | \$24.95 | 2.2 million |
| Express IRA | 2001 | \$15 opening/\$10 annual | 150,000 |

Source: Company documents.

^a \$80 is the average cost for all types of RALs, including Instant RALs. There were 4.6 million RALs made, including Instant RALs.

Note: RAL customers could get the money from their loan within 1-2 days of filing their electronic return, and RAC customers could receive their loan within 8-15 days of filing an electronic return. In comparison, tax filers who filed an electronic return would receive their tax refund within 15-22 days if the IRS sent the money via paper check and 8-15 days if the IRS sent the money via direct deposit. Tax filers who completed a paper return would receive their tax refund within 6-8 weeks if sent via paper check or within 5-7 weeks if sent via direct deposit.

Exhibit 11 Economics of Alternative Financial Services Sector

| | Revenue | Expected CAGR Revenue ^a | Average Fee | Estimated Margin |
|----------------|----------------|------------------------------------|--------------------------|----------------------|
| Check Cashing | \$1.92 billion | 2% | 2%–3% of face value | 33% ^b |
| Money Transfer | \$1 billion | 6% | \$20 per transfer | 33% ^c |
| Money Order | \$1 billion | 5% | \$0.40 –\$1.10 per order | 19% ^d |
| Payday Lending | \$2.5 billion | 14% | 15%–17% per 2 wk loan | 30%–45% ^e |

Source: Company documents.

^a Expected compound annual growth rate for revenues over the period 2001–2006.

^b Pretax profit margin.

^c Operating margins based on Western Union’s costs and revenue in 2002.

^d Operating margins based on Viad Corp.’s operating profit and total revenue for 2002 for subsidiaries MoneyGram and Travelers Express.

^e Gross margin on revenue.

Exhibit 12 H&R Block Publicly Traded Competitors, Fiscal Year 2003

| Company | H&R Block | Tax Preparation Jackson Hewitt | Check Cashing | | Money Transfer and Money Order | | Unsecured Debt | | Select LMI Targeted Banking | |
|---------------------------------|-------------------|-----------------------------------|---------------|--------------|-----------------------------------|-------------------|-----------------------|--|--------------------------------|------------------------|
| Industry Group | Personal Services | Personal Services | Ace | Cash America | First Data | Business Services | EZcorp (specialty) | World Acceptance Cnsmr. Fin. Servs. | UnionBan Cal | Popular Regional Banks |
| Revenue (\$ MM) | 3,779.8 | 171.5 | 234.3 | 437.7 | 145.5 | 1,572.1 | 206.3 | 155.7 | 2,563.9 | 2,660.2 |
| Revenue Growth ^a | 13.9% | N/A | 3.1% | 18.2% | 21.9% | -3.7% | 5.6% | 15.1% | -0.1% | 3.7% |
| Total Net Income (\$ MM) | 580.1 | 41.1 | 12.8 | 30.0 | 14.9 | 113.9 | 0.4 | 22.9 | 587.1 | 470.9 |
| EBITDA (\$ MM) | 1,241.5 | N/A | 50.4 | 70.4 | 27.6 | 157.7 | 17.9 | 42.5 | 919.3 | 1,016.2 |
| Assets (\$ MM) | 4,603.9 | 661.9 | 258.8 | 489.5 | 140.1 | 9,222.2 | 153.7 | 228.3 | 42,498.5 | 36,434.7 |
| Gross Margin ^b | 84.9% | N/A | 36.7% | 24.7% | 29.2% | 16.5% | 58.3% | N/A | N/A | N/A |
| Operating Margin ^c | 25.9% | 38.9% | 16.3% | 12.4% | 17.0% | 10.0% | 4.4% | 27.6% | 41.3% | 50.8% |
| ROE ^d | 37.1% | 6.6% | 20.4% | 12.0% | 14.3% | 14.5% | 9.4% | 18.4% | 15.2% | 17.5% |
| ROA ^e | 13.1% | 6.2% | 8.0% | 7.4% | 13.0% | 1.4% | 7.3% | 11.0% | 1.3% | 1.3% |
| Cash Flow Operating (\$ MM) | 690.8 | 64.4 | 36.1 | 75.5 | 16.1 | -172.9 | 13.3 | 55.1 | 479.6 | 562.5 |
| Cash Flow Investing (\$ MM) | 125.3 | -13.8 | -5.4 | -92.8 | -5.2 | 326.9 | -1.0 | -63.8 | -2,705.5 | -2,988.0 |
| Cash Flow Financing (\$MM) | -377.0 | -51.3 | -38.8 | 27.5 | -7.8 | -147.4 | -11.2 | 9.5 | 1,556.1 | 2,461.0 |
| Market Cap (\$ MM) ^f | 8,261.5 | 636.24 | 315.2 | 613.4 | 312.6 | 558.8 | 119.2 | 343.5 | 8,429.5 | 5,906.3 |
| P/E | 12.6 | N/A | 12.8 | 17.5 | 17.8 | 4.12 | 11.91 | 12.42 | 14.1 | 12.5 |
| P/B ^g | 4.36 | N/A | 3.19 | 2.12 | 2.44 | 0.61 | 1.06 | 2.19 | 2.1 | 2.1 |
| Beta ^h | 0.81 | NMF ⁱ | 0.66 | 0.75 | 0.53 | 1.05 | 0.40 | 0.61 | 0.79 | 0.68 |
| 1-year Return ^j | 21.3% | N/A | 122.4% | 68.4% | 153.9% | 25.7% | 119.2% | 26.8% | 39.8% | 12.3% |
| 3-year Return | 19.8% | N/A | 34.2% | 41.7% | 61.3% | 1.2% | 47.8% | 22.4% | 24.7% | 14.7% |
| 5-year Return | 17.6% | N/A | 10.4% | 10.4% | 25.3% | -1.9% | 1.9% | 25.8% | 12.5% | 10.0% |
| Bond Rating ^k | A3 | N/A | N/A | N/A | N/A | N/A | N/A | N/A | A3 | A3 |
| Number of Analysts | 8 | 1 | 4 | 7 | 5 | 3 | 2 | 4 | 12 | 3 |
| % Stock Held by Insiders | 7.5% | 0.2% | 37.5% | 3% | 29.2% | 0.4% | 25.4% | 7.9% | 65.4% | 14.0% |
| % Stock Held by Institutions | 79.4% | N/A | 36.6% | 85.9% | 49.7% | 78.2% | 53.9% | 84.2% | 92.4% | 27.8% |
| Dividend Yield | 1.8% | 0.0% | 0.0% | 0.3% | 0.0% | 5.7% | 0.0% | 0.0% | 2.5% | 2.9% |

Source: Compiled from Hoovers Online, Compustat, Thomson FirstCall, and Bloomberg Financial Markets.

^a Revenue growth is calculated over a 12-month period. ^b Gross margin is calculated as gross profit divided by revenue. ^c Operating margin is calculated as operating income divided by revenue. ^d ROA is return on assets and is calculated as the latest 12-month net income/total assets from the most recent balance sheet. ^e ROE is return on equity and is calculated as the latest 12-month net income/common stock equity from the most recent balance sheet. ^f Market cap is calculated based on share price and shares outstanding on or around July 23, 2004. ^g Calculated based on LTM revenue minus LTM cost of goods sold for the period on or around July 23, 2004. ^h Beta is calculated as a straight line fitted to 156 observations of weekly relative price changes. ⁱ Jackson Hewitt went public on June 22, 2004 with an offering of 37,500,000 shares representing a price/earnings multiple of 14.83 and a price/book multiple of 0.97 (using 2004 reported net income and equity). ^j 1-, 3-, and 5-year returns are calculated using May 2004 as the end date. ^k Bond ratings as reported by Moody's.

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