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## **OPINION: RETHINKING REBATES**

By Adam J. Fein, Ph.D.

Recent rebate accounting scandals at several large wholesale distribution companies are triggering the inevitable call for new accounting rules. The renewed scrutiny of these transactions obscures today's reality – volume rebates are a distribution management tool whose time has passed. Nonetheless, rebates serve a valuable economic purpose. Unethical behavior clearly must stop, but the competitive marketplace is already creating better ways to compensate wholesale distributors for the services they provide to their suppliers and customers.

Trade discounts, vendor rebates, and payment terms are indirect and blunt tools used by manufacturers to manage the behavior of their distributors and shift market share at retailers. The pressure to meet Wall Street expectations creates incentives for manufacturing executives to “rent” market share at the end of every quarter. Kudos to the board of cereal maker Kellogg for passing a resolution in February reaffirming an anti-channel stuffing position as a corporate practice. More manufacturers should follow this recent example.

The latest scandals reflect unethical and desperate responses to genuine business challenges facing wholesale distributors. Existing accounting standards and tax reporting requirements created an opportunity for distribution executives to record vendor payments in ways that did not reflect changing economic fundamentals. Understanding these fundamentals shows why rebates cannot be discarded without a viable alternative solution.

The growing concentration of food retailers has shifted power downstream, allowing large customers to negotiate away distribution margins. But someone still has to pay for the services and activities of the channel. As a result, manufacturers rely on trade promotions to support the legitimate costs of wholesale distribution. Wholesale distributors are unable to pass the majority of trade promotions on to consumers without facing financial ruin.

Other threats come from new alternatives to traditional wholesale distribution. In 1990, Wal-Mart decided to deal directly with manufacturers, bypassing the independent brokers and manufacturer's representatives that had traditionally serviced its stores. In less than five years, the world's largest retailer has used its complex and proprietary distribution system to grab an estimated 20 percent

share of the U.S. grocery business. Grocery wholesalers must not only contend with a declining industry, they must also deal with the shakeout among their traditional small store customers.

Wholesale distributors throughout the economy are also facing a gross margin dollar squeeze due to macroeconomic forces beyond the control of any single company in the supply chain. A strong dollar and global manufacturing overcapacity is bringing cheaper products to American consumers. China now accounts for 11 percent of U.S. imports, partly as a result of China's central bank policy that has pegged the yuan at 12 cents to the dollar since 1994. Chinese Prime Minister Zhu Rongji recently referred to this artificial currency peg as an aid to "national strength." Some analysts estimate the yuan to be undervalued by up to 40 percent.

But good news for consumers means bad news for domestic distributors. People get paid with gross margin dollars, not percents, a crucial reality when payroll and benefits account for up to two-thirds of a distributor's annual operating costs. Product price deflation means fewer gross margin dollars to cover the out-of-control costs of healthcare benefits. Distributors faced health care premium increases of 19 percent in 2002 according to a recent industry survey.

Consider wholesale prices for grocery products. Over the last 10 years, product prices have increased a mere 1.2 percent per year and actually began deflating in early 2002. In contrast, total personnel compensation costs grew at four times that rate during the same period. Wholesalers have tried to maintain a respectable return on invested capital by increasing productivity and cutting costs close to the bone, but these tactics can only go so far.

Wholesale distributors are proving once again that innovation in the marketplace is the more rewarding strategy. The winning companies are "leading from the middle" of the supply chain, thinking strategically about how to add value for suppliers and customers – and get paid for the value they add.

One logical alternative to rebates is fee-for-service pricing, which separates product costs from a distributor's costs of providing services to its customers or suppliers. A shift from markup margins on product sales to service fees provides a more direct and accountable means of measuring value and services in the supply chain. By unbundling product prices from the costs of services, distributors also have new economic incentives to create innovative services for customers and suppliers.

The strategies of pharmaceutical wholesalers offer an instructive lesson to distributors in other industries. The three largest wholesalers, which collectively handle more than ninety percent of all drugs sold to U.S. hospitals, receive only a few pennies on top of product cost for basic drug distribution. Instead of relying solely on vendor payments, these wholesalers have been at the vanguard of

adding higher margin services ranging from on-site inventory management to technology consulting. These services allow hospitals and pharmacies to provide better patient care and lower their operating costs.

A related alternative for manufacturers is functional payments that are linked to the actual activities being performed by a distributor. These payments are a more transparent and clear-cut way for manufacturers to support the costs of distributing their products. For example, this approach is being used by manufacturers who need their traditional channel to fulfill national agreements with large, multi-location retail customers. Similar initiatives can be found in almost every industry where distributors are being squeezed by powerful customers and deflationary product economics.

Manufacturers and distributors must work together to implement suitable alternatives to rebates in a changing industry. The solutions must recognize marketplace realities while legally and transparently preserving legitimate wholesale distributor compensation. This is the only way to restore investor confidence and preserve shareholder value.

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