tion system. Little additional investment would be required. The products would, of course, have to have the same target market and have similar selling and service requirements.

The more products a company markets, and the more complementary those products, the more likely it will be able to use direct distribution efficiently. Early in their life, companies tend to have a single product that by economic necessity is distributed through wholesalers. As the business matures, the product line gradually grows, increasing the economic feasibility of direct distribution. The decision to switch from indirect to direct distribution frequently arises at this stage.

Developing a direct distribution system requires substantial investment by the manufacturer. Hiring and training a sales force, building warehouses and sales offices, establishing order processing and repair facilities, prospecting for customers, and extending credit to purchasers all require investment on the part of the manufacturer building a direct distribution system. This is clearly a barrier to smaller firms and to those short of capital.

- *Wholesaler Characteristics.* The choice between direct and indirect distribution should consider the characteristics of the wholesalers who would be used. Not infrequently the decision is made to use indirect distribution only to find that the desired wholesaler is not available (see GLOSSARY entry C.42). Wholesalers may refuse to handle a product for a variety of reasons. They may feel that it does not meet customer needs, they may have a duplicate product that they feel is superior, or they may not feel that the financial incentive is adequate. In such cases, the choice is to use a less desirable wholesaler or distribute direct.

A related problem occurs when marketers of new products are forced to distribute direct to establish a track record for the product so that middlemen will accept it. This can greatly slow new product introduction. Wholesaler reluctance to handle new products can sometimes be overcome by running introductory sales promotions that create strong initial product movement (see GLOSSARY entry C.36). When rapid initial product distribution is essential, use of the existing system of wholesalers will meet the need more quickly than building a new direct system.

SUGGESTIONS FOR FURTHER READING

HLAVACEK, JAMES D., and TOMMY J. MCCUISTION. "Industrial Distributors—When, Who, and How?" *Harvard Business Review* (March–April 1983), pp. 96–101.

JACKSON, DONALD J., ROBERT F. KRAMPF, and LEONARD J. KONOPA. "Factors That Influence the Length of Industrial Channels." *Industrial Marketing Management* 11 (October 1982), pp. 263–68.

C.11 Discount Structure Determination

DISCOUNT STRUCTURE AS AN ELEMENT IN PRICING

Setting the discount structure for a product is the last step in the process for setting product price (see GLOSSARY entry C.23). Before the discount structure can be established, the basic or list price of the product must be set. The discount structure is then applied to the list price.

Function of the Discount Structure. The **discount structure** is the schedule of reductions in list price given to channel members as payment or incentive to perform services.

When a producer determines the price of a product, the price set is termed the basic or list price. Usually this list price is the intended price to the end user. If the product is sold through intermediaries, such as wholesalers and retailers, the product must be sold to them at less than list to provide them with a margin to cover their costs and provide a profit. These reductions in price are provided through discounts and allowances. Discounts and allowances are calculated based on the intermediary's selling price. Thus if a wholesaler is offered a 15 percent discount, the 15 percent is calculated from the wholesaler's selling price, not from the cost.

The discount structure serves the marketer of a product in several ways. First, it serves as payment to the channel member for services that the intermediary performs for the product. In general, the greater the services performed by a channel member, the greater the payment or discount that they will demand. Second, the discount structure can serve to provide an incentive to channel members to perform special services for a product. Special selling effort or extra advertising, for example, can be encouraged by the use of incentives built into the discount structure. Finally, marketers sometimes use the discount structure as a way of shaving the price of a product in such a way that it is less likely to be noticed by competitors and draw retaliatory price cuts.

Classes of Discounts and Allowances. Reductions from list price are offered through a variety of discounts and allowances. Discounts and allowances are similar, but the term discount is usually applied to more permanent payments for services while allowance is more often applied to special incentives for promotional support.

Practice and terminology vary substantially by industry, but several forms of discounts and allowances are commonly offered. They are described below.

- *Trade Discount.* Generally the largest and, hence, most important discount offered to intermediaries, is the **trade** or **functional discount.** The trade discount provides compensation to channel members for the basic services that they provide, such as stocking and selling the marketer's product. Trade discount amounts vary directly with the level of service provided by the intermediary.
- *Quantity Discount.* Marketers offer **quantity discounts** to channel members to encourage them to buy in large lots. When channel members buy in large quantities, the marketer's order processing and shipping costs are reduced, the costs of holding inventory are shifted to the intermediary, and the channel member is less likely to respond to competitive selling efforts. Quantity discounts can apply to individual orders or can be cumulative for a specified time period, usually a year. Legally, quantity discounts must reflect actual differences in cost or they can be considered discriminatory (see GLOSSARY entry D.2).
- *Seasonal Discounts.* To provide an incentive for channel members to order and stock a product out of season, marketers offer **seasonal discounts.** One purpose of seasonal discounts is to encourage wholesalers or retailers to stock up on the product, such as sun screen or cold remedies, in advance of a period of high demand. Another use of seasonal discounts is to encourage off-season purchases of a product, like air conditioners, to smooth the production cycle of the producer and shift inventory carrying costs to the intermediary.
- *Cash Discounts.* Discounts offered to encourage prompt payment of invoices for merchandise are termed **cash discounts.** Cash discounts are usually expressed as part of the payment terms. For example, if payment terms are 2/10, net 30, a 2 percent discount off the invoice amount is offered for payment within 10 days, otherwise the total amount is due in 30 days. Cash discounts often amount to payments well in excess of the cost of funds and are highly advantageous to channel members. (For example, with 2/10, net 30 terms, the 2 percent is paid for 20 days use of the funds or an annual rate of 36 percent.) Competition often prevents a marketer from reducing traditional cash discounts, even when it would be financially desirable to do so.
- *Promotional Allowances.* Payments or reductions in price to encourage participation in promotional events are termed **promotional allowances.** Promotional allowances come in many forms. Display allowances are offered for building in-store product displays; cooperative advertising allowances are paid to defray part of the cost of advertising by the wholesaler or retailer; PMs or push money is payment offered to retail salespeople as incentive to give selling effort to designated products. Promotional allowances are often limited time offers and are frequently provided in conjunction with a **sales promotion** (see GLOSSARY entry C.38). Promotional allowances must be offered on proportionally equal terms to customers or they could be considered a form of illegal price discrimination (see GLOSSARY entry D.2).

- *Slotting Allowances.* A relatively new occurrence is the requirement that marketers of food products pay retail supermarkets an allowance to obtain shelf space for their products. These payments, termed **slotting allowances,** reflect the increased crowding of supermarket shelves with new products and the increasing power of chain retailers.[1] (Also see GLOSSARY entry C.6.)

CONSIDERATIONS IN SETTING THE DISCOUNT STRUCTURE

Setting the discount structure involves deciding on the type and amount of discounts and allowances to be offered to channel members. There has been very little published investigation in this area. In most product categories, there is strong pressure to conform to competitive practices in setting discounts.

Process for Setting the Discount Structure. The discount structure is usually set as the fourth step in the pricing process, after the basic or list price of the product has been determined. However, it is not unusual that determining the discount structure results in a need to adjust the list price. The result of the discount structure decision may be a final selling price that is too high or may result in manufacturer margins that are too low. In either case, the pricing process must go through another cycle to make a final price decision.

Determining the discount structure can be divided into three steps. The process is summarized in Figure C.11-1.

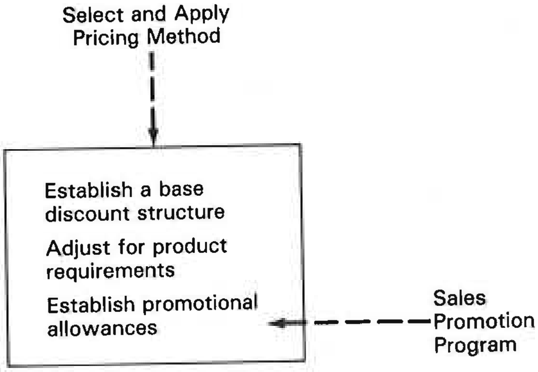

FIGURE C.11-1

Process for Determining Discount Structure

- *Use Competition as a Base.* The first step is to establish a discount structure base to which adjustments can be made. In most product categories, competitive practice will have established what discounts are offered and what the normal discount amount is. Intermediaries with strong bargaining power will insist on maintenance of these discounts and most competitors will be responsive to channel member demands in order to gain cooperation. Therefore, a good starting point in setting discounts is to adopt, as a base, the competitively established discount structure.
- *Adjust for Product Requirements.* While competition defines the discounts that must be offered to remain competitive in the distribution channel and suggests average discount levels, there is usually variation in the amount of each discount, depending upon the situation facing the individual brand. The second step, then, is to adjust the discount levels to reflect the requirements of the individual product. In the next section, some of the factors that need to be considered in making these adjustments are presented.
- *Establish Promotional Allowances.* Promotional allowances are less permanent and less bound by competitive practices. In most cases, promotional allowances are used to support sales promotions that are directed to consumers, the trade, or both. Frequently promotional allowances are considered a promotional expense, rather than part of price. Promotional allowances should be established in conjunction with **sales promotion** planning and at levels necessary to meet sales promotion needs (see GLOSSARY entry C.36).

Determinants of Discount Levels. Under the process outlined above, initially established discount levels should be adjusted to reflect the situation facing the individual brand. Some of the factors to be considered in mak-

[1] Judann Dagnoli and Laurie Freeman, "Marketers Seek Slotting-Fee Truce," *Advertising Age* (February 22, 1988), pp. 12, 68.

ing adjustments in discount levels are described below.

- *Level of Service.* In general, the higher the level of service required from channel members or the greater the risk they are asked to bear, the greater the discount must be. In order to get greater than normal selling effort for a product or higher levels of inventory or other special effort, the manufacturer must be willing to offer above average discounts. New products, because they represent above average risk to the intermediary and require above average selling effort to introduce them, are frequently introduced with above average discounts (see GLOSSARY entry C.18 on **new product introduction**).
- *Brand Leverage.* Brands that have loyal customer franchises, are strongly backed by promotion, and have dominant market shares are considered highly desirable by intermediaries. They need little in the way of special incentives to cooperate in the marketing programs for these brands and will accept discount levels that are below the average. Brands that are strongly promoted to consumers through a pull strategy can generally offer lower levels of discount to intermediaries since the brands are presold. Brands sold through a push strategy will require greater selling efforts from channel members and higher discounts as an incentive to cooperate (see GLOSSARY entry C.30 on **push versus pull**).
- *Cost versus Benefits.* For some discounts, the cost of the discount can be calculated and directly compared to the value of the benefits derived. Two examples are cash discounts and quantity discounts. In the case of the cash discount, the benefit is the interest expense saved by earlier payment of accounts receivable while the cost is the amount of the discount. If the cost exceeds the benefit and competitive conditions permit, the level of discount offered should be reduced. In the case of quantity discounts, the benefits realized by the seller are a reduction in inventory maintenance costs and a reduction in order processing costs. The cost is the amount of the quantity discount. Note in both cases that it is also desirable to examine the costs and the benefits from the buyer's side. If the discount offered does not exceed the additional costs borne by the buyer, the buyer will not cooperate by accepting the discount.[2]
- *Legal Requirements.* In adjusting discounts and allowance offered, care must be taken not to be discriminatory. Under the **Robinson-Patman Act,** which prohibits price discrimination, trade discounts and promotional allowances must be offered on proportionally equal terms to all purchasers that are in competition with one another. Quantity discounts can differ among competitors, but the differences must reflect the differences in the cost of serving those customers (see GLOSSARY entry D.2).

SUGGESTIONS FOR FURTHER READING

CROWTHER, JOHN F. "Rationale for Quantity Discounts." *Harvard Business Review* (March–April 1964), pp. 121–27.

DAGNOLI, JUDANN, and LAURIE FREEMAN. "Marketers Seek Slotting-Fee Truce." *Advertising Age* (February 22, 1988), pp. 12, 68.

[2]See John F. Crowther, "Rationale for Quantity Discounts," *Harvard Business Review* (March–April 1964), pp. 121–27.

C.12

C.12 Distribution Intensity

CHARACTERISTICS OF THE DISTRIBUTION INTENSITY DECISION

Like other decisions in designing the channel of distribution, deciding on the intensity of distribution has long-term implications. Once the decision is made, it may take many years to evolve to the desired level of distribution. Likewise, decisions to change distribution intensity take long periods of time to implement.

Levels of Distribution Intensity. The **distribution intensity** decision determines the