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Pil Hwa Yoo

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# Increase of Profits through More Effective Pricing Process

## 더 효과적인 가격책정과정을 통한 이익증대

Yoo, Pil Hwa(유 필 화)\*

본 글은 한국마케팅저널 편집규정 2조 4항에 근거한 것이다. 2조 4항: 열린 마당(open plaza)은 book review, issue, short essay 등을 다루며 A4 4-5장 정도의 분량으로 편집위원장이 원료회원 및 특정회원에게 원고를 청탁할 수 있다.

### I. Price as a powerful profit driver

$$\text{Profit} = \text{Price} \times \text{Volume} - \text{Cost}$$

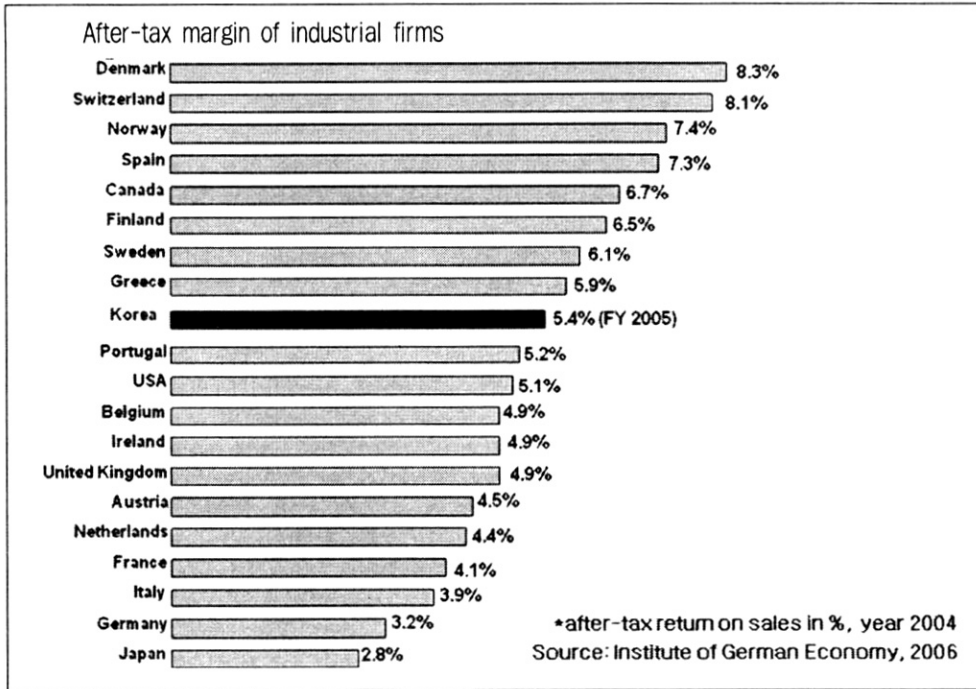
The profit situation of Korean firms is far from satisfactory. Figure 1 shows the average profitability of industrial firms in major countries of the world. We can see that the profitability of Korean firms is far below that of companies from countries like Denmark, Norway, Finland, Sweden, and so on.

What should we do about this? Before I discuss specific suggestions on this strategic issue that faces Korean companies, let me first bring up the basic profit formula, which is as follows.

This formula reminds us that there are only three profit drivers: price, volume, and cost. Since early nineties, Korean companies have made enormous efforts to reduce costs through restructuring, downsizing, and etc. and made a lot of progress in this area. The efforts to lower costs should continue because cost-reduction is always important and right. But apparently the room for improvement is becoming smaller and smaller. Thus managers should pay more attention to revenue side. On the revenue side, volume seems to be more problematic. In saturated markets, market

\* Professor of Marketing, SKK Graduate School of Business, Sungkyunkwan University(phyoo362@hitel.net)

<Figure 1> The Average Profitability of Industrial Firms in Major Countries.

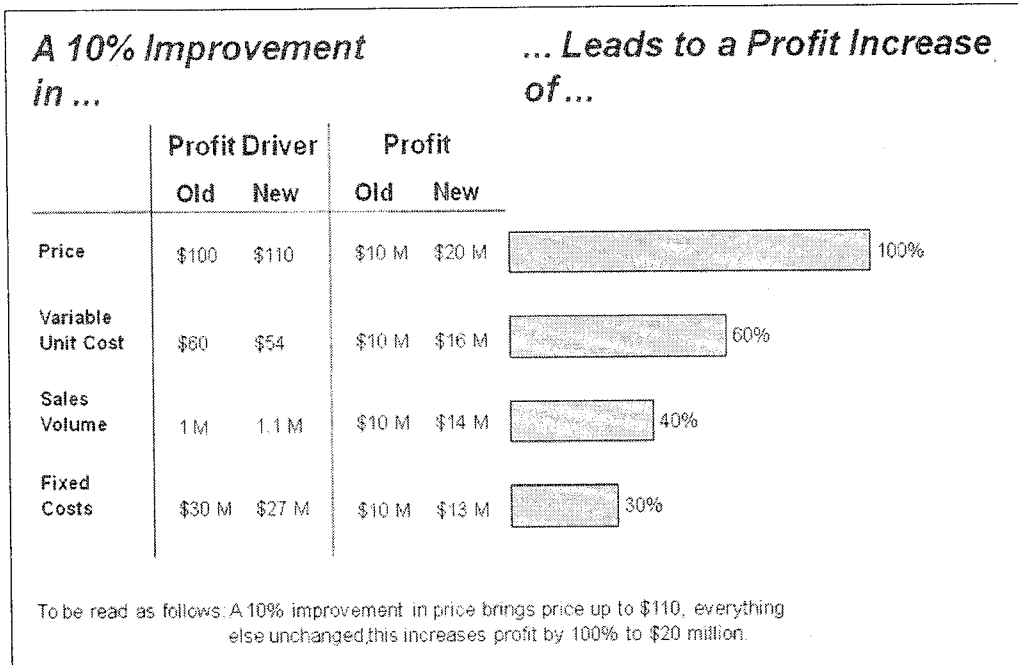


share can be gained only at the expense of competitors, who are likely to do everything to prevent that from happening. Even in relatively new markets, saturation points tend to be reached rather fast as the examples of mobile phones, internet access, and digital cameras clearly demonstrate.

In contrast to these two profit drivers, price, the third one, seems to have a much more potential. It is to be noted that price has a more impact on profit than volume. For instance, if the current gross margin is 5% and a company can raise the price by 2% without losing volume, the profit will increase by 40%. Let's assume that the variable cost is 50% of

the price. Then, if the same company manages to sell 2% more without lowering price, its profit would rise only by 20%. The reason is very simple. Whereas the impact of price changes is reflected in profitability by 100 percent, that of volume changes on profits is reduced by variable costs. Marn and Rosiello (1992) have demonstrated such a powerful impact of price change on profit, as Figure 2 shows. If we apply this insight to the case of Koreans firms, a 1% price increase would lead to a 18.5% higher profit!

<Figure 2> Price as the Most Effective Profit Driver



(Source: M. Marn and R. Rosiello, "Managing Price, Gaining Profit", Harvard Business Review, September-October 1992, pp.84~94)

## II. Pricing Process

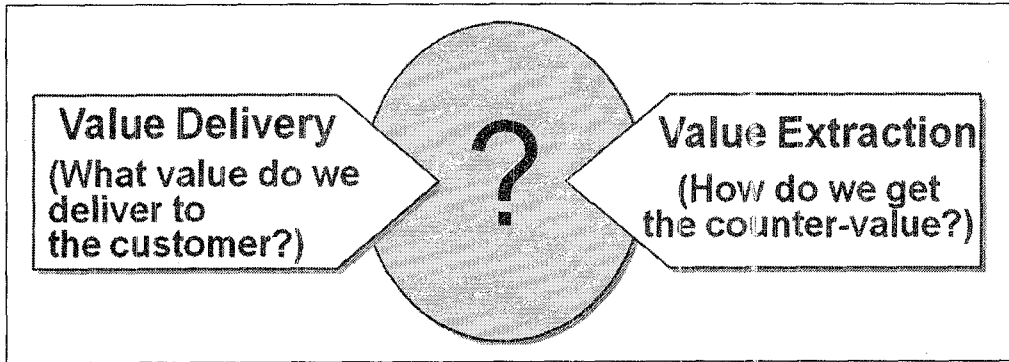
But how do we take advantage of this potential of price as a profit driver? Simply raising the list price of a product by a certain percent will not work. Nor just asking the salespeople to charge more, What is needed is a complete reorganization of so-called "pricing process." According to Simon (2004), a pricing process is

"a set of rules and procedures to determine and implement prices." It includes the following aspects.

- information, models, decision guidelines
- organization, responsibilities, incentives, timing
- competencies, qualifications
- IT support
- sequence: analysis, decision, implementation, monitoring
- objective data and subjective experience

<Figure 3> helps us understand the concept and role of pricing process. The left side is value delivery. The relevant question here is "What kind of value do we deliver to our customers?" The right side is concerned with value extraction, i.e., getting back the appropriate

<Figure 3> Value Delivery vs. Value Extraction



return. Pricing process refers to a comprehensive effort with the aim of value extraction. The question mark in the middle means that companies should constantly ask themselves whether or not they are successful in striking the optimal balance between the two.

Pricing process always plays a decisive role when a company deals with many products or when the prices are determined for each transaction through, say, negotiation. In such cases, not much time and effort can be devoted to each pricing decision. Thus companies need well-defined processes that would bring about successful value extraction, which, in turn, would lead to high profitability.

### III. The Impact of an Effective Pricing Process

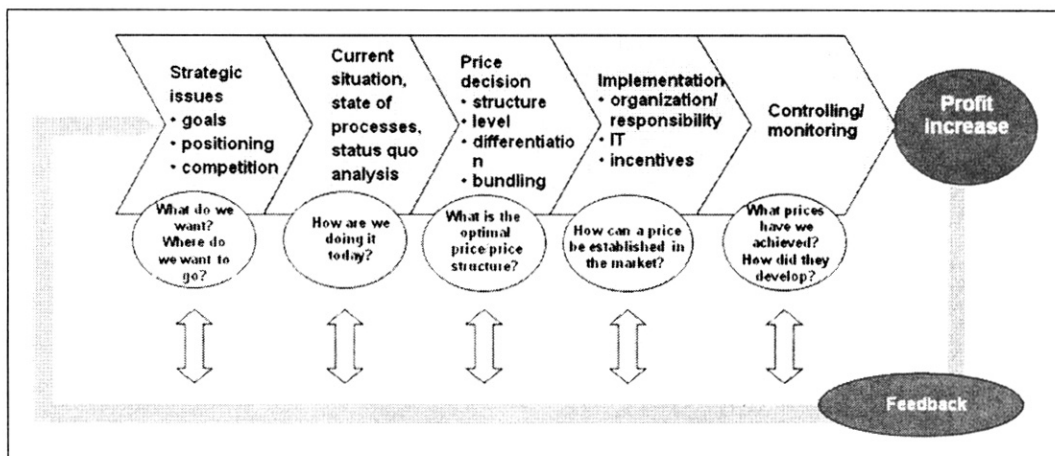
There has been almost no academic research on pricing process. There are two reasons for

this. First, these processes are very much industry- and, in many cases, company-specific, so that it takes a huge amount of time and labor to fully understand them. Second, most companies are unwilling to share the information on their pricing processes with outsiders. Simon (2004) says that his company's experience with numerous pricing process projects suggests that the improvement of pricing process can lead to an increase of profitability by 2 percent points. Given the low profitability of Korean companies, this should be regarded as revolutionary. If a company's profitability goes up by 2 percent points from 5 percent to 7 percent, that amounts to an improvement of 40 percent. Given the paucity of academic works in this area, let me just cite a couple of case examples from Simon and Sebastian (2002) and Simon (2004).

#### 3.1 anti-discount incentives

At an industrial company which deals with

<Figure 4> Stages of the Reorganization of Pricing Processes (Source: Simon 2004)



more than 40,000 articles, the salespeople had a substantial leeway in pricing. The incentive system of this company was geared toward sales revenue. The increasing competitive pressure and the incentive to reach the sales target have induced many heavy discounts. As a result of that, its profitability has gone down by 50 percent in the last five years. The introduction of an anti-discount provision reversed this negative trend. After the introduction of this new incentive system, the average discount rate went down from 16% to 14% without losing any customer. The probability rose from 4.5% to 6.5%.

### 3.2 differentiation and segmentation

In a private banking department of a big bank, target-specific differentiation turned out to be the key to the improvement of profitability. Some loyal customers reacted very

strongly to the changes in transaction terms, whereas some other segment and the new customers showed almost no reaction to the same measures. The better coordination of pricing, segmentation, and communication policy led to much higher marketing- and price-efficiency. In this case, bundling of certain service components and prices to packages played a central role, particularly for cross-selling. The profitability went up by 2 percent points.

These two cases would be sufficient to show that a reorganization of pricing processes is not simply about raising or lowering prices. In reality, the parameters that can be changed are far more comprehensive and complex: incentive system, differentiation, price structure, information, and so on. These cases are real examples of reorganization of pricing processes, which normally consists of five steps as shown in <Figure 4>. I am not going to discuss each

step in detail. For more detailed discussion, I refer the interested readers to Simon (2004).

#### IV. Conclusion

Given the low average profitability of Korean firms, they should explore every possibility of increasing their profits. Reorganization of pricing processes seems to be a very promising way to do this. In this short article, I have discussed the concept of a pricing process and a couple of cases related to it. It is said that companies can expect to raise their profitability by two percent points through more effective pricing process. This would represent a huge improvement. Top managers of each company should pay more attention to this concept because without full support of and total commitment from the top a complete reorganization of pricing processes would not succeed.

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# 더 효과적인 가격책정과정을 통한 이익증대

유필화\*

## 국문요약

한국기업의 수익률은 국제기준에 비추어볼 때 대체로 낮은 편이다. 이러한 상황을 타개하기 위해 우리 기업은 이익창출변수로서의 가격을 더 적극적으로 활용해야 한다. 왜냐하면 다른 두 이익창출변수들(원가, 판매량)에 비해 가격은 아직도 개선의 여지가 훨씬 더 많이 남아 있기 때문이다. 그러면 기업은 구체적으로 어떻게 가격을 통해 기업이 제공한 가치에 대한 대가를 회수해야 하나? 이와 관련하여 지은이는 해외의 컨설팅업체가 개발한 '가격책정과정'의 개념을 소개하고, 그것의 효과를 두 개의 사례연구를 통해 논의하였다. 또한 가격책정과정을 전면 개편하려고 할 때의 다섯 단계를 간단히 언급하고, 한국의 기업들이 이 분야에 더 관심을 많이 기울일 것을 촉구하였다.

핵심개념: 수익률, 가격, 가격책정과정

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\* 성균관대학교 SKK Graduate School of Business 교수