

Forestdale Solutions

Effects on profit – cost reduction v increased sales revenue

In the day to day fight to manage business effectively there are so many factors and issues facing the manager that it is easy to overlook the importance of good procurement and the effect this has on profit generation. As a consequence we should never lose sight of the fact that for every £1 saved on purchases translates to a £1 boost to the bottom line profit.

To take an example let us consider a manufacturing company generating a sales turnover of £40 million with a fixed profit level of 10% or £4 million. The company spends 50% of turnover on purchased materials, goods and services. Now let us look at the impact a 10% saving on purchases can make:

Sales of £40 million with 10% profit = £4 million profit

Purchases of £20 million with 10% cost reduction = £2 million additional profit

Giving a total profit = £6 million

If we ignore the cost reduction aspect and maintain a 10% fixed profit level then the company would need to increase turnover by £20 million to achieve a profit of £6 million. That is a 50% increase in sales turnover!

That is not to say we should ignore increasing turnover since sales is the life blood of any company however we should never forget the importance of effective purchasing. Faced with the task of increasing sales by 50% or achieving a 10% cost reduction we know which one we would choose to tackle.
