Revenues and Demand

Revenue

A business exists to provide goods and services. Those products are sold to customers. When a customer buys a product, that transaction becomes a sale for the business. That's what businesses do – they make **sales**.

The value of sales made is the **revenue** of the business.

You will come across some different ways of describing sales. Alternative terms for "sales" include:

- Revenue (the official accounting term)
- Income
- Sales turnover
- Takings (often used by retailers)

So we know that sales arise through the **trading activities** of a business. How are sales measured?

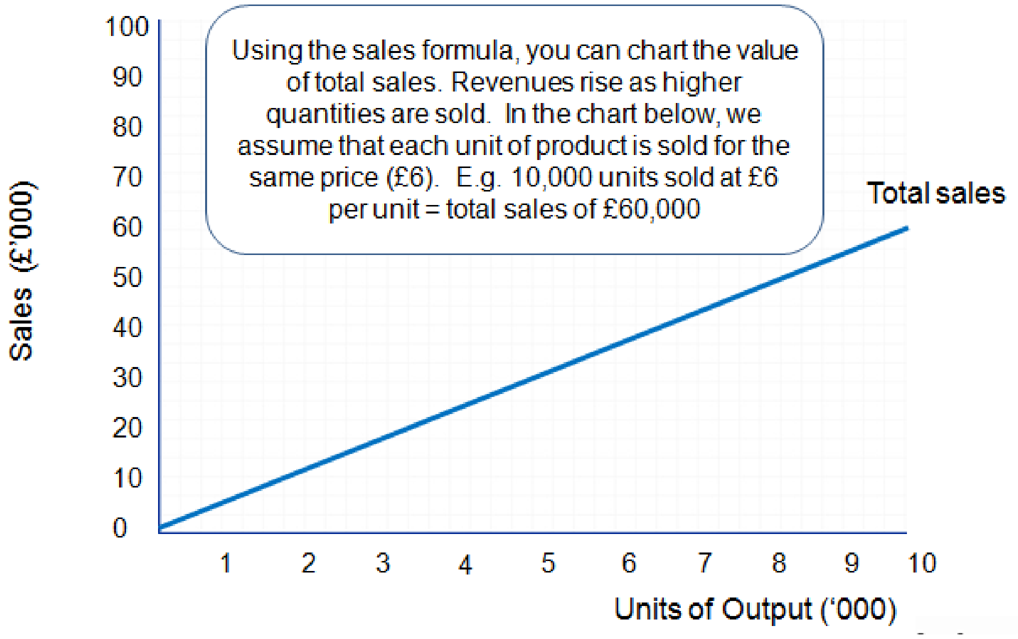
The value of revenue in a given period is a function of the **quantity** of product sold multiplied by the **price** that customers paid. Total revenue can be calculated by this formula:

Total revenue = volume sold x average selling price

A business that wants to increase revenue needs to either:

- Increase the amount or volume sold (higher quantity),
- Achieve a higher selling price,

Or (ideally) both of the above!



Calculating revenue

To see how the revenue formula works, let's look at an example.

Sheila runs a web design business. Her budgeted revenue for next year is as follows:

Quarter	Number of jobs	Average value per Job	Total revenue
Jan-Mar	6	£2,500	£15,000
Apr-Jun	7	£2,500	£17,500
Jul-Sep	5	£3,000	£15,000
Oct-Dec	8	£2,750	£22,000
Total	26	£2,673	£69,500

In the example above, Sheila is budgeting to achieve total revenues of £69,500. These sales come from a total of 26 jobs, with an average selling price per job of £2,673.

How might Sheila do better than her estimated revenue for next year?

Winning more jobs might help, although 26 jobs already looks a lot of work. Sheila may find it hard to handle higher sales volumes, unless she is able to raise capacity by employing extra designing or outsourcing elements of the work.

In Sheila's case, the solution to higher sales can probably be found in the average selling price achieved. By focusing on smaller number of higher-value jobs, Sheila may be able to increase revenues and deliver a better service.

For example, if Sheila did just 20 jobs next year (6 fewer than budget) at an average price of £4,000 per job, then her total revenues would be £80,000 (20 x £4,000), an increase over the existing sales budget of £10,500.

Demand

Demand is defined as:

The amount (quantity) that customers are prepared to buy at a given price

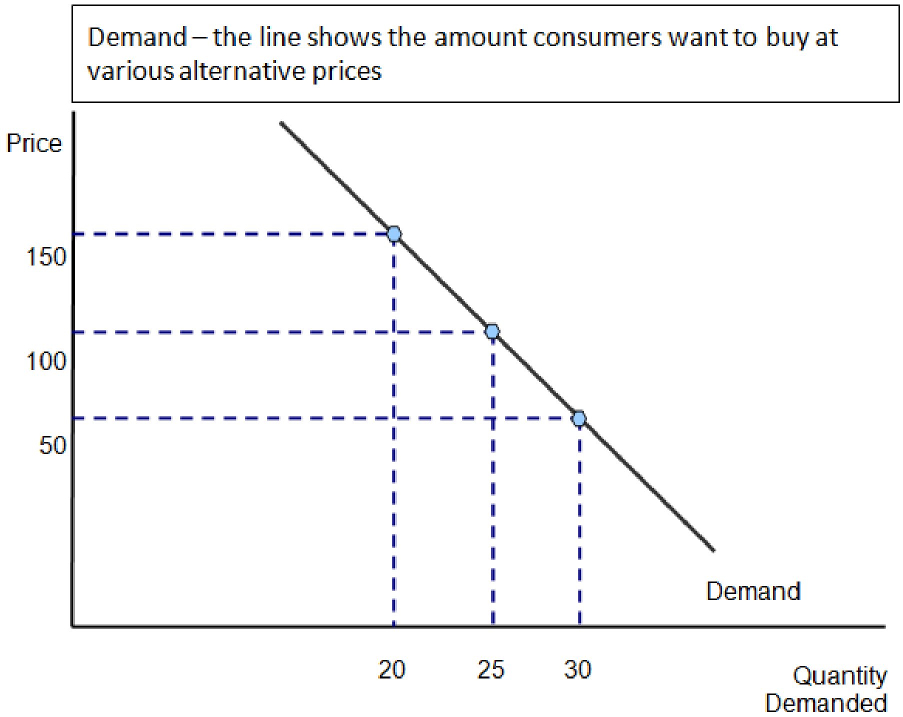
As customers, in an ideal world we would be able to buy whatever we wanted. However, we are restricted by a simple problem – we don't have unlimited money!

So, economists often prefer to talk about "**effective demand**" – which means the quantity that customers **are able to buy.**

Effective demand is all about the **ability and willingness of customers to pay** – or how much they can afford.

Normally, the quantity demanded for a product will increase if the price falls. Conversely, an increase in price will normally lead to a fall in quantity demanded.

The relationship between quantity demanded and price can be shown graphically by drawing a **demand curve**, as illustrated below:



Factors that affect demand

The demand for a product will be influenced by several factors:

Price	The most important factor that affects demand. Products have different sensitivity to changes in price. For example, demand for necessities such as bread, eggs and butter does not tend to change significantly when prices move up or down

Income levels	When an individual's income goes up, their ability to purchase goods and services increases, and this causes demand to increase. When incomes fall there will be a decrease in the demand for most goods
Consumer tastes and preferences	Can have a significant effect on demand for different products. Persuasive advertising is designed to cause a change in tastes and preferences and thereby create an increase in demand. A good example of this is the surge in sales of smoothies!
Competition	Competitors are always looking to take a bigger share of the market, perhaps by cutting their prices or by introducing a new or better version of a product
Fashions and technology	When a product becomes unfashionable or out-dated, demand can quickly fall away. The rapid decline in sales of Crocs is a great example

Problems with estimating revenues

One of the hardest tasks an entrepreneur faces with a start-up business is coming up with a realistic estimate of revenues. The main problems concern the uncertainties about:

- **The size of the available market** – how much do customers already spend in the market? Not every market is well researched, particularly those which do not involve retailing or which are not covered by official statistics.
- **The price that customers will be prepared to pay for a new product**. A new business will often assume that customers will pay a higher price than they actually will. A new product into a market often has to be offered at a discount (lower price) in order to encourage customers to buy for the first time
- **The timing and source of sales:** where will customers buy and which methods will they use (e.g. from a physical store, marketing leaflet or online store?)
- **The effectiveness of marketing activities** – by definition, new businesses start without an established customer base. Launch marketing activities often do not generate the excitement and customer buzz that is intended!
- **The response of competitors** – how will they respond to a new challenger entering the market? A start-up business cannot expect to enter a market without a challenge from the existing operators.

In general, experience shows that start-ups tend to **overestimate** their expected revenues in the first year or two.

Achieving repeat purchase

A business invests a lot of effort and cash in trying to get a customer to purchase a product for the first time. This is known as **product trial**. Much advertising is aimed at encouraging customers to try a new product, or switch from an existing competitor.

After a new product has been tried once, its success can be measured in how quickly, how often, and in what quantity it is repurchased. **Repeat purchase** refers to the number or percent of customers who purchase a second time, or to how often they buy again.

The problem with advertising is that it is very expensive. A business is unlikely to be successful and profitable if it has to keep advertising heavily in order to generate demand from new customers. It is much better if customers can be encouraged to become loyal to the product – even better, to recommend the product to their friends and family!

Achieving a high level of repeat purchase is good news for a business. So what is required?

Firstly, the product should be of the right quality. A sub-standard or low quality product is sure to disappoint first-time customers. They are unlikely to buy again or recommend the product to others.

Secondly, a business should do all it can to develop an effect relationship with existing customers. This includes activities such as:

- Regular communication (e.g. email newsletters)
- Incentives for loyalty (e.g. promotional discounts)
- Research into customer needs and wants (e.g. through customer surveys)