

## **CHAPTER 2**

### **UNDERSTANDING THE ENVIRONMENTS OF BUSINESS**

#### **CHAPTER SYNOPSIS**

All businesses, regardless of their size, location, or mission, operate within a larger external environment. This external environment consists of everything outside an organization's boundaries that might affect it. The external environment plays a major role in determining the success or failure of any organization.

The external environment is made up of several identifiable sub-environments. These include the economic environment (the conditions of the economic system in which an organization operates), the technological environment (which includes all the ways by which firms create value for their constituents), the political-legal environment (which reflects the relationship between business and government), the socio-cultural environment (the customs, values, and demographic characteristics of the society in which an organization functions), and the business environment (which includes the competitive situation in which each business finds itself).

Successful companies respond to challenges in the external environment with a variety of tactics, including mergers and acquisitions, divestitures and spinoffs, setting up employee-owned corporations, getting involved in strategic alliances, and forming subsidiary and parent corporations.

#### **CHAPTER OUTLINE**

**I. ORGANIZATIONAL BOUNDRIES AND ENVIRONMENTS** Managers must have an accurate understanding of the external environment in which their company operates, as the environment has a significant impact on its success or failure. The external environment consists of everything outside an organization's boundaries that might affect it.

A. Organizational Boundaries—These separate the organization from its environment. Today, boundaries are becoming increasingly complicated and difficult to identify, as interactions between businesses and suppliers alter traditional roles.

B. Multiple Organizational Environments—The external environment actually consists of many separate environments, including general and local economic conditions, technology, political-legal considerations, social issues, the global environment, issues of ethical and social responsibility, the business environment itself, and numerous other emerging challenges and opportunities.

**II. THE ECONOMIC ENVIRONMENT** The Economic environment refers to the conditions of the economic system in which an organization operates. The

three components of most concern are the rate of economic growth, level of unemployment and rate of inflation.

A. Economic Growth—More efficient use of resources (greater output from the same inputs, or same output with fewer inputs).

1. The business cycle—The pattern of short-term expansions and contractions in an economy, with four recognizable phases: peak, recession, trough and recovery. Concepts of recession and depression are introduced.

2. Aggregate output and the standard of living—Aggregate output refers to the total quantity of goods and services produced by an economic system during a given period. The standard of living refers to the total quantity and quality of goods and services that a country's citizens can purchase with the currency used in their economic system

3. Gross Domestic Product and GNP—Gross domestic product is the total value of all goods and services produced within a given period by a national economy through domestic factors of production, regardless of who owns the factors of production. Gross national product (GNP) refers to the total value of all goods and services produced by a national economy within a given period regardless of where the factors of production are located. The Genuine Progress Indicator (GPI) is a new measure proposed by the organization called Redefining Progress, whereby the Gross domestic product is reduced by costs that result from activities that are harmful to the environment or quality of life.

a. Real growth rates—The growth rate of GDP must be adjusted to remove the effects of inflation and changes in the value of the country's currency; this is the real growth rate of an economy. If the rate of real growth of GDP exceeds the population growth rate, the standard of living improves.

b. GDP per Capita—This refers to the GDP per person in a country. It is a better measure of the economic well being of the average person in the country than GDP.

c. Real GDP—Is calculated to remove the effects of changes in currency values and price changes. Nominal GDP is measured at current prices in current dollars.

d. Purchasing Power Parity—Exchange rates between currencies are set so that the prices of similar products in different countries are about the same. This allows for a comparison of standards of living in different countries.

4. Productivity—A measure of economic growth that compares how much a system produces with the resources needed to produce it. Improved productivity allows more output with the same inputs. As supply increases, prices

drop, consumers can purchase more, and the standard of living improves. There are several factors that help or hinder the growth of an economic system.

a.        Balance of trade—The economic value of all the products that a country exports minus the economic value of the products it imports. A positive balance of trade results when a country exports more than it imports. A negative balance of trade results when a country imports more than it exports. A positive balance of trade facilitates economic growth.

b.        National debt—A country's national debt is the amount of money that it owes to creditors. A budget deficit results when government spending exceeds government revenues (primarily in the form of taxes). If accumulated spending exceeds revenues, the government borrows to make up the shortfall.

B.        Economic Stability—A condition in an economic system in which the amount of money available and the quantity of goods and services produced are growing at about the same rate.

1.        Inflation—The occurrence of widespread price increases throughout an economic system.

a.        Measuring inflation: The CPI—The Consumer Price Index (CPI) measures the prices of a basket of typical products purchased by consumers.

2.        Deflation—A period of generally falling prices. Can result from reduced costs due to increased productivity (good) or because consumers have high debt loads and are unwilling to consume much (bad).

3.        Unemployment—The level of joblessness among people actively seeking work in an economic system. There are four different types of unemployment: frictional, season, cyclical, and structural. Wage rates vary depending on the relationship between supply of and demand for labour.

C.        Managing the Canadian Economy—The government manages the economy through both fiscal and monetary policies. Fiscal policies are government economic policies that determine how the government collects and spends its revenues. Monetary policies are government economic policies that determine the size of a nation's monetary supply, primarily through the Bank of Canada and management of interest rates. The goal of fiscal and monetary policies is to smooth out fluctuations in output and unemployment and to stabilize prices.

**III. THE TECHNOLOGICAL ENVIRONMENT** Technology has a variety of meanings, but as applied to the environment of business, it generally includes all the ways in which firms create value for their constituents.

A. **Research and Development (R&D)**—Part of the innovation process to provide new ideas for products, services and processes. Pure research seeks new knowledge, without a particular product in mind. Applied research and development focuses on making the technological innovation into a commercial success. R & D spending in Canada makes up a lower proportion of GDP than in other countries, partly because many Canadian businesses are subsidiaries of U.S. companies and the research is being done in the U.S., not Canada.

B. **Product and Service Technologies**—These are the technologies employed for creating products (both physical goods and services) for customers. Technology is important in manufacturing, but it is also a significant force in the service sector. The internet is a recent technological advance affecting all businesses. Businesses must be alert to new technologies with the potential to dramatically impact their operations. Innovative use of new technology can radically alter an industry and make an existing business or industry obsolete. R& D intensity means R&D spending as a percentage of a company's sales revenue. Companies that select a competitive strategy that relies on being a leader in technology will have greater R&D intensity. It is a riskier strategy, but has the potential for significant rewards. Other companies do not want to create technological innovations, but prefer to compete on the basis of refining the technology and finding a way to be the low-cost producer of the technology, which is less risky. Cycle time refers to the length of time it takes to accomplish a recurring activity from beginning to end. Reductions in cycle times reflect increased productivity and make the businesses more competitive. Technology transfer is the process of getting new technology out of the lab and used in practical applications in the marketplace.

C. **Process Technologies**—Are used not so much to create products as to improve a firm's performance of internal operations (such as accounting, managing information flows, creating activity reports, and so forth). They also help create better relationships with external constituents, such as suppliers and customers. Enterprise Resource Planning (ERP) is a large-scale information system for organizing and managing a firm's processes across product lines, departments, and geographic locations. The ERP system integrates the sales process with production planning and then both of these with the financial accounting system. Internal operations are coordinated with activities by outside suppliers and customers to improve scheduling of operations and response time needed. Real time processing allows the production of up-to-date financial reports at any time.

**IV. THE POLITICAL-LEGAL ENVIRONMENT** The relationship between business and government is important in Canada, as businesses are subject to government regulations. Pro- or anti-business sentiment in government can further influence business activity, whether on a federal, provincial or local level. Political stability is an important consideration for firms interested in expanding internationally. Import and export opportunities may be affected by the relations between the Canadian government and the government of a potential trading partner.

**V. THE SOCIO-CULTURAL ENVIRONMENT** This includes the customs, mores, values, and demographic characteristics of the society in which an organization functions.

A. Customer Preferences and Tastes—Customer preferences and tastes vary from one part of the country to another, and between different countries. Product usage also varies between countries, such as the marketing of bicycles as a recreational item in Canada and as a mode of transportation in many other countries. Consumer preferences and tastes change over time, with some changes driven by consumers and other driven by companies trying to increase sales. Finally, socio-cultural factors influence the standards of business conduct that are acceptable in the society, and the attitude that workers in a society have towards their jobs and their employers.

B. Ethical Compliance and Responsible Business Behaviour—This is an especially critical element of the socio-cultural environment. The central issue is the failure of businesses to provide their stakeholders with a fair accounting of their financial health and competitive position. Another important issue is the determination of appropriate ethical behaviour when different ethical standards exist in different countries and Canadian companies are expected to participate in behaviours that are acceptable in the foreign country but clearly unethical in a Canadian business setting.

**VI. THE BUSINESS ENVIRONMENT** The business environment includes expectations of customers, suppliers, shareholders, and employees. Current trends such as a more global economy are also an important element of the business environment.

A. The Industry Environment—Understanding the competitive environment in which a business operates is critical to developing a successful competitive strategy. One of the most popular tools for analyzing the competitiveness of the industry is Michael Porter's five forces model. The stronger the forces, the more competitive the industry, and the more difficult it is for an individual company to operate profitably. If the forces are strong, the company normally has little ability to set its own selling prices and must be able to produce at a low cost to be profitable. The five forces are as follows:

1. Rivalry among existing competitors—This refers to the amount of competition between businesses in an industry.
2. Threat of potential entrants—The lower the barriers to entry, the easier it is for new competitors to enter the market and influence the industry.
3. Suppliers—The existence of few suppliers limits the opportunities a company has to obtain the inputs it needs and provides the suppliers with strong bargaining power.

4. Buyers—The existence of few customers when there are many suppliers provides the customers with strong bargaining power.

5. Substitutes—If substitutes are readily available for the product a company sells, the industry is more competitive.

B. Emerging Challenges and Opportunities in the Environment of Business—Companies are refocusing on their core competencies, those skills and resources with which they can gain a competitive advantage and create the most value for owners. Outsourcing activities that are outside their core competencies to businesses that do have the expertise needed can reduce the costs of performing those functions, but create dependencies on those suppliers.

1. Outsourcing—The strategy of paying suppliers and distributors to perform certain business processes or to provide needed materials or resources.

2. Social Media and Viral marketing—The strategy of using the Internet and word-of-mouth marketing to spread product information. Using various formats—games, contests, chat rooms, and bulletin boards—marketers encourage potential customers to try out products and tell other people about them.

3. Business Process Management—A process is any activity that adds value to some input by transforming it into an output for a customer (whether internal or external). Business process management involves creating team structures focused on processes rather than functional areas of business. By identifying those activities that are critical to the business' success, the processes that must be performed well to effectively carry out these activities, and then ensuring the necessary skills and resources are available, decision-making is faster and more customer-oriented, materials and production are better coordinated and products are delivered more rapidly.

**VII. REDRAWING CORPORATE BOUNDARIES** Companies are joining together in a variety of ways in order to take advantage of opportunities more effectively than is possible alone. Various methods have been used in recent years.

A. Acquisitions and Mergers—In an acquisition, one company simply buys another one. In a merger, the arrangement is more collaborative process, where two firms are consolidated into one. A horizontal merger occurs when two firms that have been direct competitors in the same industry now become one firm. A vertical merger is one where two companies that had previously been in a customer-supplier relationship join together. In a conglomerate merger, two firms completely different industries join together. A friendly takeover is an acquisition in which management of the acquired firm supports the change in ownership. A hostile takeover is one in which the management of the acquired firm fights the attempt by another firm to acquire control. A poison pill is a defence that management adopts to make a firm less attractive in the event of an attempted hostile takeover.

B.      Divestitures and Spinoffs—A divestiture means the sale of part of an existing business operation to another company. A spinoff is the strategy of setting up one or more corporate units as independent businesses, motivated by the belief that the unit will be more valuable as a separate company.

C.      Employee Owned Corporations—Employee stock ownership plans develop when corporations buy back their own shares on the stock market, transfer the stock to a trustee for the benefit of the employees, who then gain ownership of the stock through prearranged terms.

D.      Strategic Alliances—The joining together of two or more companies on a temporary basis to undertake a particular project. Benefits include spreading the risk of the project between the allied businesses, and the sharing of expertise.

E.      Subsidiary and Parent Corporations—A subsidiary corporation is a corporation that is owned by another corporation (through the acquisition of more than 50 percent of the voting shares). A parent corporation is a corporation that owns (or controls) the subsidiary.

### QUICK QUESTIONS

1.      How will the various phases in the business cycle affect a small manufacturing firm?
2.      How can economic growth be measured through aggregate output, standard of living, gross domestic product, and productivity?
3.      How does the national debt affect economic growth?
4.      Why have the items in the “basket of goods” making up the CPI changed over the years?
5.      In what ways does the technological environment affect business activity?
6.      In what ways does the political-legal environment affect business activity?
7.      In what ways does the socio-cultural environment affect business activity?
8.      Explain how the factors in Porter’s Five Forces model are relevant to the competition between Chartered Accountants and Certified General Accountants.
9.      What is the difference between GDP and GNP?

### IN-CLASS EXERCISES

#### **Exercise #1—Business Accountability Handout: Outsourcing**

##### **Activity Overview:**

This activity asks students to give some serious thought to the issue of outsourcing and its effect on the Canadian economy and on Canadian workers.

**Time Limit:** 30 minutes

##### **What to Do:**

1.      Make sure that students are familiar with outsourcing before you divide them into groups. Ask them to read two write-ups about outsourcing below, one focusing

mainly on Canada, and the other on the U.S. Make copies of this material and hand it out to students in advance.

## Canada

*During the last decade or so, outsourcing has become increasingly popular because (a) it helps firms focus attention on their core activities and avoid getting sidetracked by secondary activities, and (b) it reduces costs. The Bank of Montreal (BMO), for example, outsourced its human resource processing services to Exult Inc., which now manages payroll and benefits administration, employee records, HR call centre services, and other functions that used to be performed in-house at BMO. The new arrangement means a 20 percent reduction in HR costs for BMO, and it also frees up BMO managers to concentrate on more value-added work.*

*Outsourcing decisions like the one at BMO involve moving jobs from one company to another within Canada, but a lot of outsourcing involves moving jobs from Canada to a foreign country (often called offshoring). Because of this, much concern has been evident about Canadian job losses. But outsourcing may actually be beneficial to Canada. If you wonder how that could be possible, the reasoning goes something like this: Canadian companies outsource certain kinds of work in order to take advantage of low-cost foreign suppliers. This allows Canadian companies to reduce their costs and increase their productivity which, in turn, helps them to be more competitive in global markets. Greater competitiveness of Canadian firms in international markets means more success, more jobs, and a higher standard of living for Canadians.*

*Even if we accept this line of reasoning, that doesn't mean that outsourcing is without problems. A study by the Toronto-based Centre for Outsourcing Research and Education found that less than 50 percent of companies that have tried outsourcing are satisfied with it. A study by Dun & Bradstreet found that one-quarter of all outsourcing relationships fail within two years, and one-half fail within five years. One of the problems is that members of the "stay-back team"—the individuals who are responsible for managing the new outsourcing relationship—are under pressure to not only cut costs, but also to increase the quality of the services that have been outsourced. In addition, managers complain that suppliers don't understand what they are supposed to do, they charge too much, and they provide poor service. Moreover, when disruptions occur in the supply chain, the costs to both parties can be high. Replacing failed outsourced operations can be very expensive, especially if the firm wants to go back to performing the outsourced activity itself. Another risk is the loss of control over both operations and information.*

*The problem that Boeing Corp. has had getting its new 787 Dreamliner jet to market illustrates the problem that can arise because of outsourcing. Boeing was supposed to deliver the first 787 to All Nippon Airways in May 2008, but now the date has been pushed back until 2010. These delays will cost Boeing millions of dollars in penalties for failure to deliver the new aircraft on time to the 50 different airlines that have placed orders for nearly 900 of the new jets. To reduce*



*development costs for the 787, Boeing decided to outsource and have different parts suppliers build different sections of the plane. These parts suppliers are located all over the world. For example, the nose section is made by a subsidiary of Toronto-based Onex Corp., the rear fuselage section is made at a factory in South Carolina, the middle fuselage section is made in Italy, and the wings are made in Japan. The idea was that these various sections (subassemblies) would then be put together at Boeing's Seattle, Washington production facility.*

*To make this system work, a great deal of discretion was given to the various makers of these subassemblies. But several major problems have arisen: (1) the first 787 subassembly that was sent to Seattle by a supplier was missing literally thousands of parts; (2) parts suppliers have had trouble handling tasks that Boeing employees knew how to do because of their many years of experience in building airplanes; (3) suppliers further outsourced key tasks like engineering to other companies; and (4) subassemblies were not completed on time.*

*What can managers do to reduce the risks of outsourcing? They monitor the procedures that suppliers use when making the product or providing the service, visit suppliers to inspect the premises, talk to the people who are actually making the product or delivering the service, and ensure that needed information flows from the suppliers back to the company. Overall, companies who outsource must clearly stipulate how the outsourcing process is going to work, and how much authority and responsibility suppliers have. For example, the company doing the outsourcing must determine whether the supplier has the right to do further outsourcing. They must also stipulate performance expectations for the supplier, and specify how the product is to be made. When Terrapin Communications Inc. outsourced production of its main product—a high-tech bracelet called Safety Turtle which has an alarm that goes off if it is immersed in water—to Baja Technology Inc. in Zhuhai, China, it stipulated that Baja had to follow detailed instructions when making the bracelet. For example, Baja cannot substitute parts, and they must adhere closely to the bill of materials.*

*In spite of the potential problems with outsourcing, the practice is likely here to stay because of the increasingly global nature of business. Indian companies like Wipro and Infosys are now offering more sophisticated services than previously. For example, Wipro now offers to manage all of a company's information technology (IT) needs rather than just troubleshooting for the company's IT department, and Infosys has entered the management consulting field. These companies are also opening offices in other countries. Tata Consultancy Service has offices in Canada as well as in several South American countries, while Wipro has offices in Canada, the U.S., and the Middle East. All of this change means that a Canadian company with an Anglo-German parent firm might outsource its IT functions to a firm in India, and that firm would send the actual work to the Czech Republic. That's globalization in action.*

**U.S.**

*Businesses are accountable to numerous external constituents. Also, managers sometimes have to optimize their decision making when dealing with conflicting interests. Nowhere is this more visible than in the current debate over the continued outsourcing of jobs to foreign employees.*

*Outsourcing is not a recent phenomenon. For years manufacturers have subcontracted their labour to low-cost factories in developing nations. Nike and Reebok, for instance, outsource the production of all their athletic shoes to factories in Southeast Asia. And many other companies have similar practices. In general, the jobs that have been outsourced have been relatively low-skill in nature. While labor and other observers have long been aware of this practice, business leaders have been able to argue with some conviction that this practice would lead to more high-quality jobs in places like the United States.*

*In recent years, a major change in outsourcing has occurred as more companies have started to outsource skilled and/or white-collar jobs to other countries. Companies like Microsoft find that highly skilled software programmers in places like India can perform as well as their U.S. counterparts for about a quarter of the salary costs. Boeing is now having some of its engineering work done abroad. And some experts are beginning to visualize how many other basic services, ranging from income tax preparation to financial analysis to medical records interpretation, can also be exported. How big is the problem? Experts project that 3.3 million jobs will be exported from the United States by 2015, and that another 14 million jobs have been identified as being “at risk.” Many experts also agree that while outsourcing may be bad for various specific individuals, in the long term it will be good for the country as a whole. And besides, as one CEO argues, “If your competitor is sending jobs overseas, you’re almost forced to do the same.”*

*That sentiment sums up the debate nicely. On the one hand, if businesses are accountable to their shareholders, they are obligated to keep their costs as low as possible and to remain competitive in their respective marketplaces. From this perspective, then, they should outsource whenever and wherever feasible. On the other hand, to the extent that businesses have a social obligation and an obligation to their current workers, they must take into account the social and human cost of displacing U.S. workers. So which side is right? This is a case in which there is no simple answer, and what is right or wrong is in the eye of the beholder.*

2. Divide students into three- or four-member groups and ask them to discuss within their groups the pros and cons of (a) outsourcing in order to keep prices down, and (b) reducing dependence on outsourcing in order to better fulfill social obligations toward stakeholders. (15 minutes)
3. Reassemble the class and discuss each group’s opinions. (15 minutes)

**Don’t Forget:**

This is a case in which there is no simple answer!

**Wrap-Up:**

Wrap up the activity by reminding students that some industries may rely more heavily on outsourcing than others. Further, some industries gain higher-quality standards and expertise through outsourcing. Also remind students of positive trade relationships that evolve through dependence on outsourcing.

**Exercise #2—Experiential Exercise: Competing For Your Business****Activity Overview:**

The purpose of this exercise is to demonstrate the “invisible hand theory” by voting with your dollars.

**Time:** 50 minutes

**What To Do:**

1. Divide the class in half. Divide one half into teams of three or four students. Each team will be the owners of a video store. The other half of the class will act as customers (see below).
2. Each store will develop an offering they think is unique (15 minutes). The group designated as customers should list their criteria for choosing a video store.
3. The entrepreneurs will explain their store’s offering to the rest of the class who are potential customers (10 minutes).
4. Customers will line up in front of the store of their choice. Count the people in front of each store (5 minutes).

**Follow-up Questions:**

1. Is one store more popular than the others? Why is that?
2. What can the less-popular stores do to attract customers?
3. How would that affect the most-popular store?
4. Are the customers voting with their dollars?

**Exercise #3—Corporate Reputations****Activity Overview:**

This activity is designed to help students assess the information in a case study, and then answer questions that are relevant to material presented in the chapter.

**Time Limit:** 25 minutes

**What to Do:**

1. Break your class into small groups and have them read the material below. (5 minutes)

*There has recently been a lot of negative publicity about business firms because of (a) illegal and unethical behaviour by business executives, and (b) the economic woes that started in 2008. But some corporations continue to perform well, and to do good things for their stakeholders.*

*Each year, the Reputation Institute publishes Global Pulse, which ranks the world's 1000 largest companies according to their reputation with their stakeholders. Each company's score is determined by how well it scores on key performance indicators like products/services, innovation, workplace, citizenship, governance, and leadership. Top performers in recent years have been Toyota (Japan), Google (U.S.), IKEA (Sweden), Ferrero (Italy), and Johnson & Johnson (U.S.).*

*A list of the most respected corporations in Canada is published by KPMG/Ipsos-Reid. Several hundred leading Canadian CEO's are asked to assess Canadian corporations on eight performance categories such as long-term investment value, innovation and product/service development, financial performance, corporate social responsibility, corporate governance, human resource management, and customer service. In one recent survey, the top-ranked companies were the Royal Bank of Canada, Research in Motion, EnCana Corp., and WestJet Airlines.*

*Surveys about corporate reputations are also conducted in the U.S. The Reputation Quotient study is a joint effort of Harris Interactive Inc., a Rochester, New York-based research firm, and the Reputation Institute of New York. Its survey asks more than 20,000 people to name two companies with the best reputation and two companies with the worst reputation. Respondents evaluate the companies on factors such as emotional appeal, financial performance, social responsibility, vision and leadership, and workplace environment. In total, 60 companies were ranked. In one recent survey, 88 percent of respondents rated the reputation of American business as either "not good" or "terrible."*

*It's not just individual companies that can run into difficulty. During the last few years, the reputations of entire industries have declined. For example, the reputations of the financial and automobile industries have declined sharply since the recession began in 2008. Consumer impressions of the pharmaceutical and oil industries are also negative because of a widely held belief that these industries are overcharging consumers for the products they sell. The tobacco industry has also had problems because consumers think that information about the negative effects of smoking and nicotine were withheld from the public.*

*When we consider negative information about business firms, we must remember that only a very small proportion of them are actually engaging in illegal or unethical behavior. A review of the global, Canadian, and U.S. reputation lists—and the criteria that are used to generate them—provides some reassuring testimony about the vitality and values of many businesses. It also shows the manner in which they conduct their operations, and gives us some insights into how companies must perform to gain the kind of stellar reputation necessary to get on the list.*

*These criteria all have one underlying theme: They reflect in one way or another the extent to which an organization and its managers effectively meet or exceed the needs and expectations of their external constituents. For example, hiring and developing the brightest and most motivated people from the labour*

*market results in high levels of employee talent. Likewise, respecting the needs of shareholders and other investors affects several criteria, including financial soundness, use of corporate assets, and long-term investment value. Says one expert, “We admire companies that cater to their constituents.”*

### **Questions for Discussion**

1. *What is your opinion of the value of the rankings like these? How might the different ways the Canadian and U.S. surveys are conducted influence the results?*
2. *Do you think the criteria that are used are appropriate? Can you suggest others?*
3. *Is the ranking something that investors should rely on in buying stock?*
4. *If you were a top manager and wanted your firm to move up in the rankings, how would you proceed?*

2. Assign each group one of the questions for discussion found at the end of the case study. (10 minutes)
3. After the groups have completed their respective answers, reassemble the class and discuss each question. (10 minutes)

### **Don’t Forget:**

Ask students during the discussion time whether managers should be concerned about ratings such as these, and whether there is any relationship between how well or poorly a company rates and how well or poorly the company does in the marketplace.

### **Wrap-Up:**

Remind students that the corporate scandals of the past few years have received a lot of publicity. Ask them whether they think this has reduced student interest in a career in business.

### **Exercise #4—What’s Going on Out There?**

#### **Activity Overview:**

This activity is designed to increase student awareness of the external environment of business, and to understand how various parts of the external environment can impact businesses.

#### **Time Limit: 25 minutes**

#### **What to Do:**

1. Divide the class into three-member groups.
2. Assign each group a specific industry (for example: apparel, automotive, airline, fast food, computer, apparel, restaurant, etc.).
3. Ask each group to assess how important each of the elements of the external environment (economic, technological, political-legal, socio-cultural, and business) is for their assigned industry. (15 minutes)

4. Ask a spokesperson from each group to briefly summarize the group's conclusions. (10 minutes)

**Don't Forget:**

Remind students that (a) the relative importance of the various environmental elements is somewhat different for each industry, and (b) the environmental elements can change substantially over time.

**Wrap-Up:**

Make sure that students understand that businesses cannot just passively sit by and hope that the external environment will be favourable. Strategic planning is necessary in order to position the business for future success. To do this requires assessment of likely future trends and how those trends will impact the specific products and services the company is providing.

### TEACHING TIPS

1. Ask students to identify current events or conditions which may impact the success of a business today. Specify which organizational environment is involved for each current event or condition.
2. Have students form groups and discuss/list all the external factors (global, national, provincial or municipal) that have influenced specific businesses in their city of residence.
3. Before starting the chapter, ask students to form groups and define inflation, debt, and deficit. Ask them why it is important to reduce the debt and ask them to provide solutions to the problem. Students should recognize that debt is created when consumption exceeds resources. To pay down debt, consumption must be less than the resources available.
4. If two project groups each produced a ten-page term paper by the end of a term, but one group had six members and the other group had three members, which group was more productive? The answer often leads to a good discussion of the relationship between quality and productivity measures.
5. Ask the students when a recession becomes a depression. Have them look up various down turns in the economy on the Internet. Students may be surprised to hear that the Canadian economy has suffered more than just one or two recessions over the last hundred years. Keep in mind there is no “official” benchmark on when a recession becomes a depression. Although the best answer may be from former U.S. president Harry Truman: “It’s a recession when your neighbour loses his job; it’s a depression when you lose your own.”
6. Ask students which Canadians benefit when the Canadian government incurred the annual deficits that have now grown to an accumulated debt of nearly \$500 billion. Ask students their opinions on who should be responsible for paying

down the debt, and what impact the debt reduction initiatives will have on the economy. Does it matter whether the debt is held by Canadians or individuals and organizations outside Canada?

7. Ask students to describe the monetary policy currently in place in Canada. What does this indicate about the current state of the Canadian economy? What would be the expected change in interest rates if the government felt that the economy was slowing down and there was a strong possibility of a recession? Why might that not work?
8. Ask students to identify current events, court rulings, or legislation which present threats or opportunities for businesses. For example, what impact does a war have on business, and why? What about reducing the maximum length of a mortgage from 40 years to 30 years?
9. Ask students to describe their class. Identify the obvious demographic characteristics and also those factors, which may not be disclosed, such as, religion, sexual orientation, etc. Now speculate on how these factors might impact the decisions made by a business. Are there any opportunities? Threats?
10. Have students look up Canada's balance of trade. Ask them about the importance of the American market. Do they see a need to diversify trading partners? Is it feasible to do that?
11. Ask students to explain how the sovereign debt crisis in Europe might influence the Canadian economy.
12. Ask students to identify political events taking place in other countries and the potential impact that these events could have on Canadian businesses.
13. Ask students to identify technological innovations that have had a profound effect on an industry. There are a wide variety of examples from both the present and the past that may be discussed. Past innovations include the gas powered motor, which allowed for the development of the automobile and the decline in businesses which manufactured wagons and carts, harnesses, etc. This also leads to the development of a network of service stations. If alternate fuel sources are successfully developed, what impact will that have on current industries? In the current environment, the development of internet capabilities has had a significant impact on many industries, including the music recording industry. What impact has the internet had on the sale of encyclopaedias?
14. Make sure that students understand that gross domestic product includes only the value of products produced within a nation's borders; the figure includes the value of products produced by both domestic and foreign companies within those borders.
15. Reinforce that gross national product includes the value of products produced by a country regardless of where they are produced; this figure does not include the value of products produced within the country by a foreign company.

16. Make sure students understand that inflation occurs when overall price levels go up because too much money is floating around; as a result, purchasing power declines.
17. Reinforce the concept that the government regulates the money supply and interest rates through monetary policy.

### USING THE BOXED INSERTS

#### **Opening Case: Video Content Providers Must Evolve or Perish: Netflix and Beyond.**

The opening case describes the challenges of doing business in an industry where technological change is occurring at a rapid pace. The rise of Netflix as a potent force in the movie delivery business is noted, as is the fall of formerly successful Blockbuster. The main focus of the case is on the numerous environmental threats that Netflix faces (changes in government regulation, unhappy customers, increasing costs, competition from other content providers, and great uncertainty about where the industry is headed. This opening case demonstrates the important conceptual point that the external environment has a major effect on business firms.

The opening case will interest students because it focuses on one aspect of the entertainment industry. A good way to demonstrate the importance of the external environment is to have students identify the key elements of the environment (see Figure 2.1) and ask students to explain the relative importance of each of those elements for Netflix.

#### **Managing in Turbulent Times: What Should We Do About R&D?**

##### **Critical Thinking Questions**

This boxed insert addresses the important issue of research and development expenditures in Canada, how these expenditures have lagged behind other industrialized nations for many years, and what might be done to improve the situation.

1. Why do you think Canada lags behind other industrialized countries in R&D?

Some students will say that Canada lags behind other industrialized countries because Canada's population is so much smaller than that of Japan, Germany, and the U.S. Canada is indeed the smallest country in terms of population, but by itself, that fact cannot explain the differences because R&D is stated as a *percentage* of GDP, and that obviously takes population into account because GDP is heavily influenced by population. (Note: Because Canada's population is relatively small, and because R&D expenditures are a very small percentage of GDP, the *absolute*



amount of dollars spent on R&D in Canada is just a tiny fraction of what is spent in the other countries.)

Canada's small population may well have caused another factor to become important, and that is Canada's so-called "branch plant economy." Over the years, many foreign-based companies (particularly U.S. companies) have established operations in Canada, but major decisions about the business (including R&D) are made in the home country, not Canada. These foreign-based companies do not conduct much R&D in Canada. Rather, R&D expenditures are made in their home country and the more day-to-day operations that are needed to produce and sell products are carried out in Canada. Canadian managers in these companies have often complained that they do not have much say in the big decisions that are made (including R&D expenditures).

Ask students whether they think these two factors really explain why R&D is lower in Canada than in many other industrialized countries. What kind of data would they need to determine if these arguments are true?

2. Do you think increased government involvement in R&D will improve Canada's position? Explain your reasoning.

Students invariably divide into two camps when considering a question like this. Those who think that increased government involvement in R&D will improve Canada's position will argue that coordination of R&D is needed if we hope to improve the levels of R&D in Canada, and the federal and provincial governments can provide this coordination. Other students will scoff at this notion and will argue that the government's track record to date does not offer much hope of good coordination or better results. These students will argue that the private sector must be the main focus for R&D.

This is not a simple issue, so students should be encouraged to read various opinions on this issue. They should be directed to the "sources" for the boxed insert, which are listed at the end of the text.

### **The Greening of Business: What's The Latest On The Hydrogen Fuel Cell?**

The boxed insert describes the slow process that has been evident with respect to the hydrogen fuel cell. Despite its promise, it still seems to be years away from truly widely commercial use.

### **Critical Thinking Questions**

1. Review the section on new product development in Chapter 16. At what stage of the new product development process is the hydrogen fuel cell?

The hydrogen fuel cell is in the product testing and test marketing stage. There are limited numbers of both cars and buses which are powered by fuel cells,

but as the case notes, the hydrogen fuel cell is nowhere near ready for the mass market. The fuel cell may be in this stage of the process for many years.

2. Consider the following statement: *If the fuel cell had any value, it would have been fully developed by now and there would already be many cars on the road that are powered by the fuel cell.* Do you agree or disagree with the statement? Explain your reasoning.

This statement is a useful starting point for a class debate on this issue. Students who agree with the statement will point to the hundreds of millions of dollars that have been spent so far, and will note that although many years have passed, the fuel cell is still stuck in the product testing stage. Other students will disagree with the statement and will point out that it can take many years for new product ideas to really catch on.

As part of the discussion, students should be encouraged to think of products that took many years to develop before they became successful, as well as products that after many years in development never quite made it to commercialization. They should then think about the differences between these two classes of new products. The development of the automobile, radio, television, and computers are good examples of products that took a long time to develop but eventually became successful. The rotary engine is an example of a product that was in development many years, but never became widely adopted.

### **Entrepreneurship and New Ventures: Battle of the Glen**

Nova Scotia-based Glenora Distilleries has been battling to keep the term “Glen” in their brand name. The Scotch Whisky Association argues that the use of “Glen” in the brand is confusing consumers.

#### **Critical Thinking Question**

1. Which of the external environments have had the most effect on Glenora Distilleries?

The political-legal environment has had the biggest effect on Glenora Distilleries since it has had to fight legal battles about the right to name its products. Distillers in Scotland have been aggressively trying to protect the use of the word “scotch,” and have been quite successful. The economic environment has also affected Glenora since demand for various distilled products varies from place to place around the world. The business environment has also had an effect in terms of competition in the industry.

### **E-Business and Social Media Solutions: Corus Entertainment Looking For Listeners and Revenues in New Places**

This boxed insert describes the rapid changes that have taken place in how consumers are using products like cameras, phones, and television in ways that they

were not used just a few years ago. These changes in consumer consumption patterns have presented problems for traditional media outlets like radio stations, and they are looking for ways to attract new listeners by linking to Facebook, My Space, and YouTube. Developments at Corus Entertainment that are illustrative of new consumption patterns are described.

### **Critical Thinking Question**

1. How do you listen to music? Have you joined or visited a social media group linked to your favourite stations? Why or why not?

The material presented in this boxed insert provides the starting point for an in-class discussion which should be very interesting to students because it raises issues of consumer consumption patterns that are understandable to them because they are important users of such services. It is best to identify several students ahead of time who have joined a social media group and ask them to describe their experiences. Students who have not joined such a group should also be asked why they have not done so. Differences in attitudes between the two groups can then be examined.

### **QUESTIONS FOR ANALYSIS**

1. Why is it important for managers to understand the environment in which their businesses operate?

The environment in which the business operates has a significant effect on the operating activities of the firm and its profitability. Managers must understand the threats posed by direct competitors and companies producing substitute products or services. Managers must also understand the limitations on their business activities that arise from the political-legal environment. Managers must be aware that technological changes can alter the competitive environment very quickly, and accordingly must be monitoring the technological environment for new technology that is beneficial or detrimental to their business operations.

2. It has been argued that inflation is both good and bad. How can this be? Explain. Are government efforts to control inflation well advised? Explain?

Inflation is bad because it can lead to a spiral of rising wages chasing rising prices, which must rise to cover the cost of increased wages. It is good because it can signal the beginning of a period of growth for the economy. Government tries to control inflation by adjusting interest rates through monetary policy. If the economy is strong and inflation is occurring because demand exceeds supply, a tight monetary policy can reduce demand and slow inflation and the economy to an acceptable level.

3. What are the benefits and risks of outsourcing? What, if anything, should be done about the problem of Canadian companies outsourcing jobs to foreign countries?

Benefits: reducing costs, avoiding idle capacity, availing of experts in a particular field, transferring operational responsibilities to another firm. Risks: relinquishing operational control, creating dependency, facing reliability issues, neglecting management supply chain

Students will have different opinions on whether or not something should be done. Students who want something done may recommend government actions to make outsourcing to foreign countries less desirable, such as instituting tariffs and fees on products imported into Canada. They may also recommend legislation to prohibit outsourcing to a foreign company. Students who believe that nothing should be done are likely to support their position on the grounds that businesses should have the opportunity to take their businesses wherever they like, and that government should not interfere with their opportunity to earn greater profits by utilizing outsourcing. Students may present the argument that the trend may be short term. If quality and service issues arise, the trend may reverse.

4. Explain how current economic indicators such as inflation and unemployment affect you personally. Explain how they will affect you as a manager.

Answers will vary. Inflation measures the increase in prices of products which impacts consumer purchasing power (CPI) and other personal aspects. It indicates the required increase in earnings that must be achieved in order to maintain the existing standard of living. It is also, to a certain extent, a gauge of how well the overall economy is performing, and that has a bearing on our personal lives as well.

Unemployment: Information on cyclical unemployment levels may provide information on the difficulty a student may face if he or she is interested in relocating and changing jobs. Information on structural unemployment may be relevant to students who are still trying to identify what type of careers they would like to have

As a manager, information on inflation may be used when preparing a budget of expected revenues and expenses for the upcoming year. Inflation rates may be used for such things as establishing selling prices for goods and services produced, and negotiating wages and wage increases for employees. Information on unemployment levels may be used to assess the likelihood that sufficient new staff can be hired to meet the staffing needs of the company, which includes such things as replacing individuals who are retiring, or the addition of new personnel to staff new divisions.

5. At first glance, it might seem as though the goals of economic growth and stability are inconsistent with one another. How can you reconcile this apparent inconsistency?

Economic growth is desirable to increase employment, output, and wealth creation. At the same time, stability is necessary in order to have a sustainable

standard of living. If inflation and unemployment are very high, consumer purchasing power is seriously eroded, and businesses have difficulty operating.

6. What is the current climate regarding the regulation of business? How might it affect you if you were a manager today?

Answers will vary. There are conflicting trends today. Increased concern about global warming and environmental protection has created a trend towards increased regulation of emissions and waste. Concerns about a lessening of competition led the government to disallow the merger between the Royal Bank and the Bank of Montreal. At the same time, however, a number of industries have been deregulated, such as the airline industry.

As a manager, one would need to be aware of the entire range of regulations that are relevant to the type of operating activities carried out, as there may be limitations on the decisions that could be made. Additionally, failure to comply with regulations can result in a range of serious consequences, such as loss of licences, impositions of fines, and jail time.

### **APPLICATION EXERCISES**

1. Select two businesses with which you are familiar. Identify the major elements of their environments that are most likely to affect them in important and meaningful ways.

Answers will vary. When assessing examples that students provide, make sure that they are analyzing the key elements of the particular environment. For example, if a small business is selected and the student says that the business environment is critical, an analysis of issues such as rivalry among competitors, threat of potential entrants, suppliers, buyers, and substitutes must be evident. If a large business that exports to foreign markets is chosen, there should be an analysis of the characteristics of the political-legal environment (in both Canada and in the targeted foreign country) and the implications of those characteristics for sales success.

2. Assume that you are the owner of an internet pharmacy that sells prescription drugs to U.S. citizens. Analyze the factors in the external environment (economic, technological, political-legal, and socio-cultural) that might facilitate your company's activities. Analyze the factors in the external environment that might threaten your company's activities.

Answers will vary, but the political-legal environment will be important because laws that are made in the U.S. regarding prescription drugs may inhibit or facilitate the sale of prescription drugs from Canada. The economic environment will also be important, particularly exchange rates. As the value of the Canadian dollar has risen, the advantage for Canadian internet pharmacies has declined.

3. Select a technology product, such as Amazon's Kindle e-reader, and research how the various environments of business (economic, technological, socio-cultural, global, political-legal, and general business) are currently impacting the sales possibilities of the product or service.

Each of the external environments of business has some impact, but some environments will be seen by students are more salient. For example, students who pick a product like the Kindle e-reader will recognize that the economic environment has an overall influence (i.e., when times are good, consumers purchase more products like a Kindle e-reader), but they are more likely to say that the technology and socio-cultural environments have a bigger influence for that particular product. The technological environment is influential because consumers in the 18-35 age bracket are attracted to the latest technological gadgets. This fact obviously has positive implications for sales. The socio-cultural environment is also important because having the latest electronic gadget can be an important issue in one's social standing.

If students view an automobile as a technology product, the following ideas would be relevant:

*Political-legal environment:* will include environmental protection legislation that will set emission standards the manufacturer will have to meet in order for the automobiles produced to be sold. *Economic environment:* if the economy is strong, sales should also be strong as customers with money to spend acquire new automobiles. If the economy is weak however, sales of automobiles may decline substantially, as automobiles are durable goods with a long life, and automobile owners may decide to drive the automobiles they already own for a much longer period of time. *Socio-cultural environment:* products that are environmentally-friendly are increasingly valued. As a result, automobiles that are not fuel-efficient may not sell well, while automobiles that run on alternative fuels may sell very well. This may also impact the total sales volume of the industry, as some individuals will opt for public transportation rather than purchasing a car. Consumer preferences for particular colours, standard versus automatic transmission, front-wheel drive, rear wheel drive or four wheel drive, etc. will all affect which automobiles sell best. *Technological environment:* technological advances such as improved safety features may increase customer demand for some automobiles compared to others, which affects sales of particular models. Technological changes such as the manufacture of small scooters have affected the overall demand for automobiles, rather than just a preference for one particular type over another.

Students who pick a service (for example, a university or college education) will identify other environments as significant. For example, students might conclude that the political-legal environment is very important because provincial government decisions about tuition rates are very important to them.

4. Interview two business owners or managers. Ask them the following questions: (a) What business functions, if any, do they outsource? (2) Are they

focusing more attention on business process management now than in the past? (c) How have internet applications and the growth of social media changed the way they conduct business?

Answers will vary. When assessing student answers for exercises of this type, it is useful to summarize students' interview findings for each of the questions and then provide the summary to the class. This will give them a much more accurate picture of general trends. For example, for question (a), a summary will indicate whether there are distinct patterns in terms of the functions which are outsourced. The summary for question (c) will probably be of most interest to students because they will be able to see a connection between their interest in social media and the relevance of social media for businesses.

## **BUILDING YOUR BUSINESS SKILLS**

### **Feeling the Heat from Bad Results: Praying for Good Weather**

1. How could Rona better prepare and handle negative weather patterns?

One option is to discount the price of certain products that have been negatively influenced by unfavourable weather. Management obviously does not want to do this, but it is costly to carry inventory that is not moving off the shelves, so they may have to discount. They can analyze the trade-offs between incurring increased inventory carrying costs and receiving a lower price for the products they have to discount. Another possibility is to keep only minimal inventory until a pattern becomes apparent in the weather (either negative or positive). This strategy is not simple, but with Canada's reliable transportation system, products can be brought in very quickly to replenish stock if more favourable weather conditions suddenly develop. But it is clear that alternatives like these are largely reactive, not proactive. And it is difficult to be proactive regarding the weather.

2. Are unfavourable natural weather patterns more dangerous for major retailers like Rona or small businesses? Provide at least one argument on each side before making a choice.

It could be argued that unfavourable weather patterns are more dangerous for a small retailer because the small retailer has fewer financial resources to fall back on if weather depresses sales. The lack of financial resources means that one misstep by a small retailer may drive it out of business. Put another way, a small retailer has less ability to weather the financial storm that may be created by poor weather.

On the other hand, it could be argued that unfavourable weather could be more dangerous for a major retailer because the major retailer counts so much on a high volume of products that, at various times during the year, may be necessary in order to smooth out the overall fluctuations in demand for the total range of products that the company sells. At Rona, for example, gardening supplies and equipment are an important contributor to profitability during the spring season. When the weather

doesn't cooperate, profit declines, investors are unhappy, and the value of the company's stock may decline.

This question can be expanded by asking students to develop a list of organizations that will be hurt by a certain weather pattern (e.g., a cold spring) and a list of organizations that might benefit from exactly the same weather conditions.

3. Is it possible for a manager to spend too much time trying to anticipate future events? Why or why not?

Managers should spend considerable time trying to anticipate future events if (a) the events pose a threat to the company's survival, and (b) if the potential events can be predicted with a fair chance of success. This is the essence of contingency planning (see Chapter 6). For example, it is useful for a company making smart phones to monitor the latest technological developments as it tries to predict new product offerings that competitors may develop. But spending time trying to anticipate future events which are essentially unpredictable (e.g., a volcanic eruption that causes commercial passenger flights to be cancelled, or a terrorist attack, or unusual weather that will affect consumer demand) is not advisable (even though such events may have a very negative effect on the company).

Planning is a crucial management function (see Chapter 6), but spending a lot of time trying to predict events in the *distant future* is not likely worth the effort. A good example is predicting the supply of oil (see Concluding Case 1-1). While it is interesting to read about the vigorous debates between supporters and opponents of "peak oil," the main conclusion is this: it's hard to know what is going to happen because there are so many factors that enter into the equation. Managers who spend a lot of time on this issue are unlikely to get a good return for their effort (i.e., an accurate prediction that will help their company do well).

## EXERCISING YOUR ETHICS: TEAM EXERCISE

### Finding the Balance

#### **Activity Overview:**

This activity asks students to role-play and share their views on ethics in a real-world situation.

**Time Limit:** 35 minutes

#### **What to Do:**

1. Divide students into four-member teams and ask them to read and follow the instructions for the Exercising Your Ethics: Team Exercise found at the end of Chapter 2. Students should each choose one of the different roles in the exercise. (20 minutes)



2. Reassemble the class as a whole and discuss what disagreements came up within their groups. How did the role they played affect their perspective? (15 minutes)

**Don't Forget:**

Remind students that what one individual or group considers unethical may not be considered unethical by another individual or group.

**Wrap-Up:**

Wrap up the activity by reminding students that striking the right ethical balance between an organization and employees can be difficult because there is much room for ethical ambiguity. And when other agents—customers, competitors, stockholders, suppliers, dealers, and unions—come into play, reaching an ethical balance is especially challenging. The right ethical balance involves creating a situation in which all parties involved can benefit in the best way possible.

## CASE ANALYSES

### **Concluding Case 2-1: Air Canada's Challenging Environment: Competition, Economic Crisis, Fuel Prices, Volcanoes, and More**

1. Identify the various environmental factors which influence Air Canada. Which of these are most important? Explain.

Before addressing the specifics of the Air Canada case, it is useful to briefly summarize the *general* impact of the external environment on business operations. The *economic* environment has a very obvious influence on business firms. The business cycle, for example, influences the willingness and ability of consumers to purchase goods and services that companies make available. In good economic times, demand is high and companies find it relatively easy to make a profit. When an economic downturn occurs, however, consumers cut back their purchases and most firms find it much more difficult to make a profit. The *technological* environment influences the kinds of goods and services that businesses can feasibly deliver to customers. New products that are the result of R &D can make large profits for some companies while creating difficulties for other companies that are trying to market obsolete products. The *socio-cultural* environment has a very large effect on business firms because consumer preferences and tastes determine the kinds of goods and services that consumers see as desirable, and because consumer perceptions about what constitutes ethical behaviour cannot be ignored. The *political-legal* environment influences the relationship between business firms and government, and is usually seen in the restrictive legislation that is passed to control business activity. The *global* environment has a large impact on Canadian businesses because such a large proportion of domestic production is exported. This means that Canadian products must be competitive internationally. The *business* environment identifies several groups that make demands on businesses: consumers, employees, suppliers, and shareholders.

With regard to the specifics of the Air Canada case, several environmental factors have clearly had an impact (competition, government regulation, volcanic eruptions, weather, rising fuel costs, a global recession, and airport security challenges). Student answers should demonstrate that they have systematically worked through the case to identify these environmental factors and understand their placement (as shown in Figure 2.1). For example, the *technological* environment is important because new airplane models are constantly being introduced, and airlines have to decide which, if any, of the new alternatives should be purchased. The *economic* environment is important because the ups and downs in the business cycle affect the demand for air travel. The *business* environment is important because of the intense competition in the industry. Some students might say that the *physical* environment (which is not represented in Figure 2.1) should be added to the figure because it can also have a positive or negative effect on airline operations. More generally, the physical environment has become increasingly relevant for business firms as a result of the increased focus on pollution, global warming, and protecting the environment.

The same type of analysis that is described above can be conducted for any industry, and it is helpful for students if the instructor provides other examples. Consider such an analysis for the automobile industry, which (similar to question #3 in the Application Exercises) might look something like this: The *economic* environment has a major impact on the automobile industry because the purchase of an automobile is a major decision for most consumers. A downturn in the business cycle and the uncertainty it creates means that consumers are less likely to buy a new car and will instead make repairs to their current one in order to keep it running. This obviously reduces demand for new cars. The *technological* environment also has a major impact on the automobile industry because it influences the kinds of cars that are feasible to make. At present, there is much talk about electric cars, and cars powered by hydrogen fuel cells. But the technology still needs work and much uncertainty is created for both consumers and manufacturers about the time frame of development of these technologies. This makes it difficult for car makers to plan for the introduction of cars powered by these new technologies. The *socio-cultural* environment is important because it demonstrates the strength of consumer preferences for, say, “green” cars, but it also interacts with the technological environment (consumers may want “green” cars but they may not be available because of technological problems). The *political-legal* environment has a continuing influence on car makers (for example, pollution control legislation), but on certain occasions this environment may have unusual prominence (such as when government bailouts are given to companies like GM and Chrysler). The impact of the *global* environment can also clearly be seen, as foreign car companies have become very competitive and have taken market share from domestic manufacturers like Ford, GM, and Chrysler. The *business* environment is also relevant because consumer demands for high quality products have created intense competition among domestic and foreign car makers. Problems with mass layoffs of workers are also evident as car makers struggle to remain competitive.

2. How does the multi-year planning timeframe regarding the purchasing of aircraft impact management decisions?

Stated simply, the multi-year timeframe regarding the purchase of aircraft has a significant impact on management decisions because events that might occur three or four years in the future are much more difficult to predict than events that might occur just a few days or weeks in the future.

There is much uncertainty in the external environment that companies have to cope with. For example, a significant factor in the economic environment is the business cycle. In the expansionary phase of the business cycle, demand increases for most products and services, including air travel (for business and pleasure). If the cycle was predictable, the purchasing of aircraft could be accurately planned to coincide with periods of increased demand. But as events of the last few years have shown, predicting the business cycle is not easy.

3. How do unpredictable events impact Air Canada? Give examples.

Perhaps the most obvious example of an unpredictable event impacting Air Canada is the volcanic eruption in Iceland that disrupted air travel in Europe and North America. That eruption cost airlines literally millions of dollars as flights were cancelled and airline companies had to scramble to deal with a huge backlog of stranded customers.

4. What can Air Canada do to reduce the negative impact of environmental factors that complicate its activities?

Managers cannot generally control the elements in the external environment, but that does not mean that their only alternative is to simply react to environmental changes. Managers must regularly scan the external environment to increase their understanding of the elements that are likely to affect their particular firm. Such research is likely to yield insights into trends that will present opportunities or challenges to the company. An obvious example is demographic research showing predicted age distributions in the Canadian population. Changes in the distribution over the years (proportionally more older people and fewer younger people) have some fairly obvious implications for the kinds of products and services that will be in greater (or lesser) demand. Anticipating other kinds of environmental disruptions (for example a volcanic eruption) is generally not possible, but many other changes in the external environment can be anticipated, at least to some extent.

Contingency planning and crisis management (see Chapter 6) are both necessary activities for companies that want to deal as effectively as possible with the external environment.

In answering this question, some students may make take a rather fatalistic position and say that managers in business firms cannot control many of the important elements in the external environment. To support their argument, they may give examples of companies that are at the mercy of trends which are beyond their control (for example, rising fuel costs). Other students (who may have a somewhat negative view of business) may argue that business managers actually *do*

control the elements in the external environment, and they do so to the detriment of consumers. They may argue, for example, that companies manipulate supply (and therefore price) or that advertising manipulates consumers and causes them to buy things they don't really need. These opposing arguments can easily form the basis of a debate about a different aspect of the external environment, namely, whether business firms have too much control over what goes on in society.

5. How do government regulations of the commercial airline business affect Air Canada?

In the most general sense, government regulation constrains what a company can do. In Air Canada's case, for example, government regulation takes the form of which routes it is allowed to fly, the timing of flights, and how much it has to pay for landing fees. The issue of landing fees has become quite important in recent years. More and more Canadians are crossing the U.S. border by car and then flying from U.S. airports because air fares are cheaper there. Canadian airline companies say that the Canadian government has made it difficult for them to be profitable because the government has increased security fees, airport improvement fees, and federal and provincial fuel excise taxes. This makes it more expensive to land a plane in Canada than in the U.S. Air Canada, for example, pays \$3400 to land an Airbus 320 in Canada's largest airports, but only \$1650 in the U.S. On the positive side, an agreement between Canada and the EU created new opportunities by reducing restrictions for Air Canada and EU airlines. This allowed Air Canada to launch new direct services to five popular European gateway cities.

### **Concluding Case 2-2: Inflationary Pressure/Deflationary Pressure and the Validity of the CPI**

1. Based on your own observations in the marketplace, do you believe we are in an inflationary or deflationary period?

If we use the Consumer Price Index (CPI) as the basis for our answer, we are clearly in a period of relatively low inflation (about 2 percent annually). The much more interesting question here is whether the CPI really captures the level of inflation as experienced by the average consumer. The CPI's use of the "basket of goods" idea seems like a good one to capture the average consumer's experience with inflation, but in recent years critics have argued that inflation is really much higher than the government says it is.

Consumers tend to be very sensitive to price increases, so some students (perhaps a majority) might also argue that inflation is much higher than 2 percent. They may even be able to provide specific examples from their own experience showing that prices of certain products have increased far more than 2 percent (e.g., tuition). But general impressions cannot be a substitute for a systematic analysis of price movements. Student answers should demonstrate an understanding of the "basket of goods" concept and the price movements over time of that basket of goods.

A more challenging task is to determine whether the CPI adequately reflects actual inflation from the average consumer's perspective. To address this issue, students should read two short articles that come to different conclusions about the CPI. The first (Phil Green, "Hiding Inflation," *National Post*, April 29, 2010, FP11) concludes that the CPI understates inflation, while the second (Brian Milner, "Statscan Overstates CPI," *The Globe and Mail*, March 9, 2011, B5) says that the CPI overstates inflation.

2. Go to the Bank of Canada website and find the latest inflation figures. Based on the latest statistics, is inflation or deflation the biggest problem today?

Student answers will vary depending on the time when they answer this question. As of mid-2012, inflation was running at about 2 percent annually (as it has been for several years). During the last 50 years, inflation has routinely been a much bigger concern than deflation, but in recent years, there have been some predictions that deflation may become a problem as the global business environment continues to be fragile.

3. What do you think of Phil Green's contention that the CPI has become a deceptive tool? Do you believe that governments are purposefully massaging the numbers? If so, explain why.

Many people have concerns about the way government operates, and these concerns can lead to a readiness to uncritically accept claims that the government is doing something unreasonable. What is needed is a critical analysis of such claims, in this case, the claim that the CPI has become a deceptive tool for the government to mislead consumers about the magnitude of price increases.

As noted in question #1 above, this question provides a good opportunity to require students to critically analyze an article that makes a specific claim. Whether students agree or disagree with the conclusions of the article, they must make a distinction between the *facts* presented and the author's *opinions*. They should also consider the magnitude of the leap that is necessary to go from the facts to conclusions about what the facts mean.

For example, in the article the point is made that the way inflation is measured has changed over the years, and if we use the old method, inflation is much higher than what is reported. This is a fact, but this fact raises an important point: which method (the old or the new) is most appropriate? It may not be easy to make that determination since consumer purchasing patterns and the "basket of goods" have both changed over time. The other major problem involves deciding how to address the issue of improved quality in products. The approach is to reduce the actual price of a product to take into account the increased quality that is built into the product. But how much should the price be reduced for purposes of determining inflation? And even if there is agreement on this issue, consumers still have to pay the regular price when they buy the product. Issues like these should be addressed in the students' critical analyses.

# CHAPTER 2

## UNDERSTANDING THE ENVIRONMENTS OF BUSINESS



# Learning Objectives

1. Explain the concepts of *organizational boundaries* and *multiple organizational environments*.
2. Explain the importance of the *economic environment* to business and identify the factors used to evaluate the performance of an economic system.
3. Describe the *technological environment* and its role in business.
4. Describe the *political-legal environment* and its role in business.

# Learning Objectives

5. Describe the *socio-cultural environment* and its role in business.
6. Identify emerging challenges and opportunities in the *business environment*.
7. Understand the recent trends in the redrawing of corporate boundaries.



# Organizational Boundaries and Environments

(LO 2-1)

- External Environment
  - factors beyond an organization's boundaries that cannot be controlled
- Organizational Boundaries
  - that which separates the organization from its environment

# Dimensions of the External Environment

(LO 2-1)

## Multiple Organizational Environments

**Economic environment**

**Technological environment**

**Political-legal environment**

**Socio-cultural environment**

**Business environment**

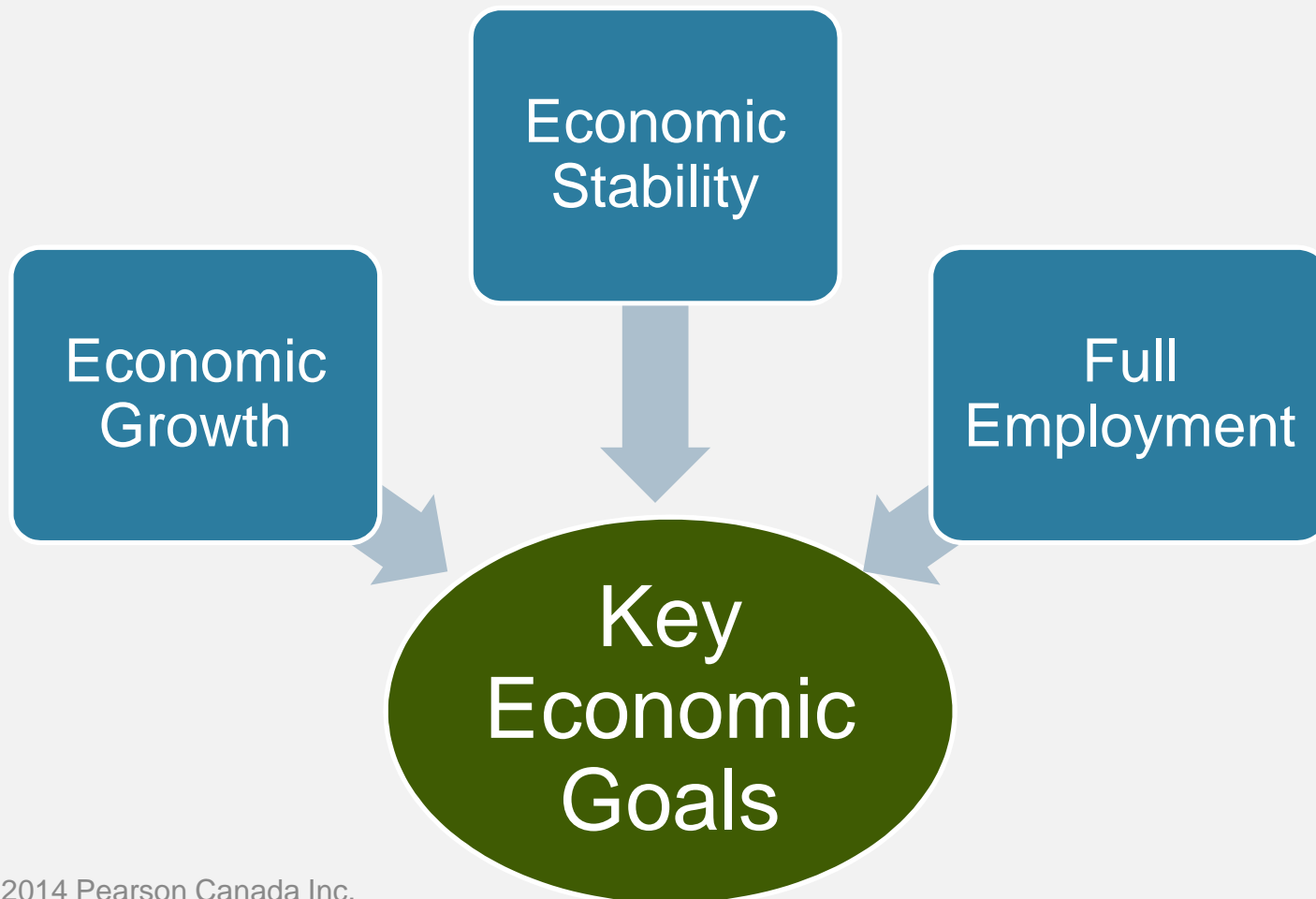
**Global environment**

**Emerging challenges and opportunities**

# The Economic Environment

(LO 2-2)

- The conditions of the economic system in which an organization operates



# The Economic Environment

(LO 2-2)

## Economic Growth Overview

*The Business Cycle*

*Aggregate Output and the Standard of Living*

*Gross Domestic Product (GDP) and Gross National Product (GNP)*

*Productivity*

*Balance of Trade*

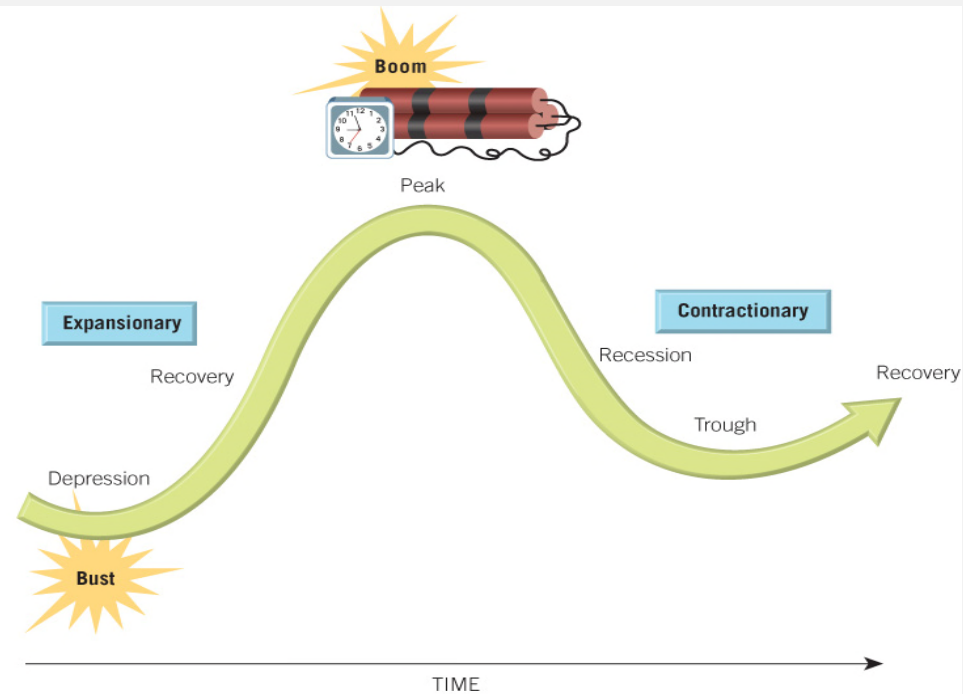
*National Debt*

# The Economic Environment

(LO 2-2)

- **Business Cycle**

- The typical pattern of short-term ups and downs in an economy (peak, recession, trough and recovery)



**FIGURE 2.2**

The business cycle.

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# The Economic Environment

(LO 2-2)

- Aggregate Output
  - Measure of economic growth
  - Total quantity of goods and services produced by an economic system during a given period
- Standard of Living
  - Total quantity and quality of goods and services that a country's citizens can purchase with their currency

# The Economic Environment

(LO 2-2)

## Measuring Economic Growth

- Gross Domestic Product (GDP)
  - value of all goods and services produced by a national economy within a given period through domestic factors of production
  
- Gross National Product (GNP)
  - value of all goods and services produced by a national economy within a given period regardless of production location

# The Economic Environment

(LO 2-2)

- Productivity
  - Standard of living improves through increases in productivity
  - Measure of economic growth that compares the output of an economic system with the resources that are needed to produce the output



# The Economic Environment

(LO 2-2)

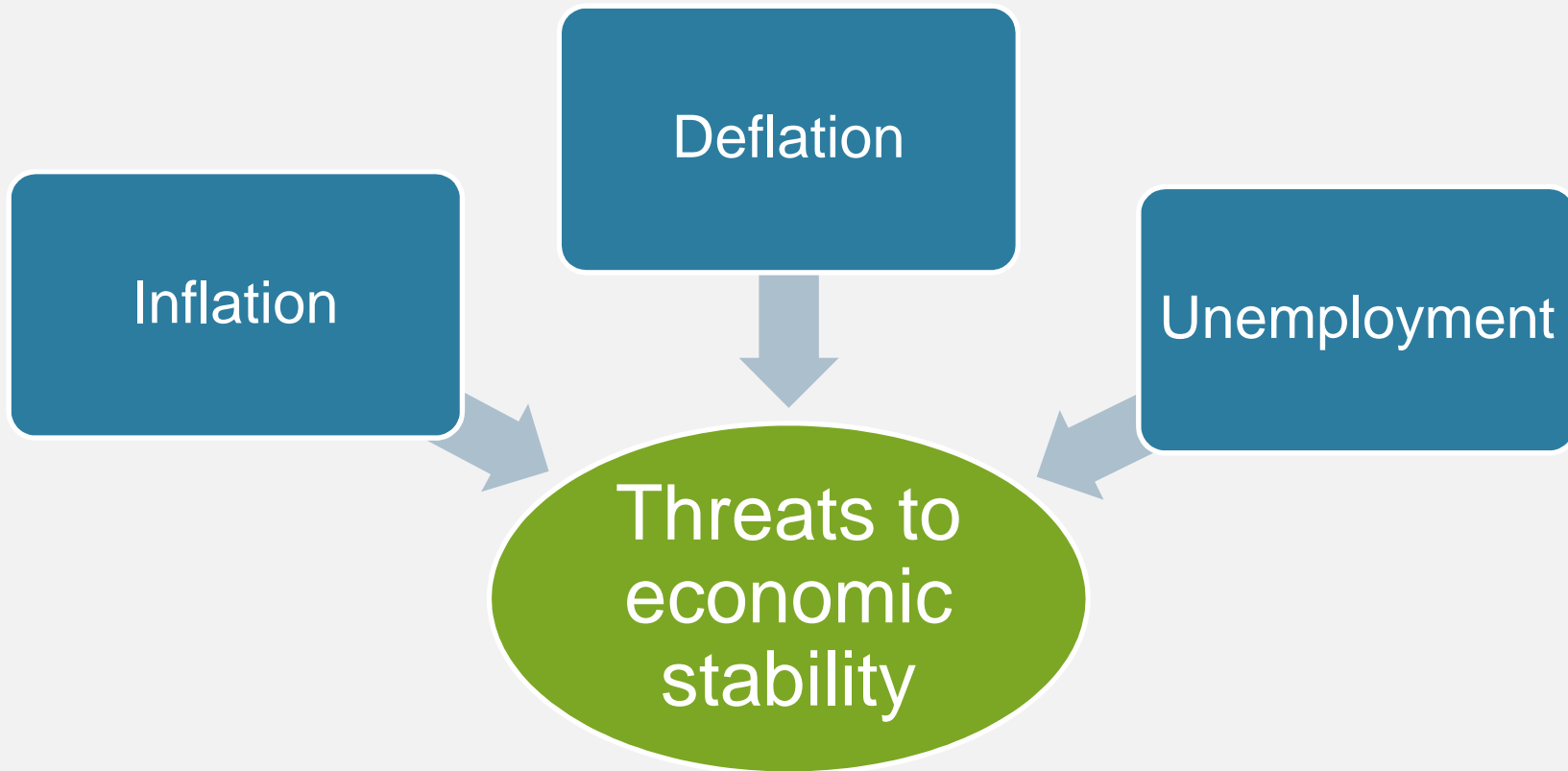
- Balance of Trade
  - Value of all exported products minus the value of imported products
- National Debt
  - Amount of money that a government owes its creditors
  - Increases by the amount of the budget deficit
  - Can decrease when an economy has a budget surplus

# The Economic Environment

(LO 2-2)

- **Economic Stability**

- Condition in an economic system in which the amount of money available and the quantity of goods and services produced are growing at about the same rate



# The Economic Environment

(LO 2-2)

- Inflation
  - Occurs when there is widespread price increases in an economic system
- The Consumer Price Index (CPI)
  - Tool used to measure inflation
- Deflation
  - A period of generally falling prices

# The Economic Environment

(LO 2-2)

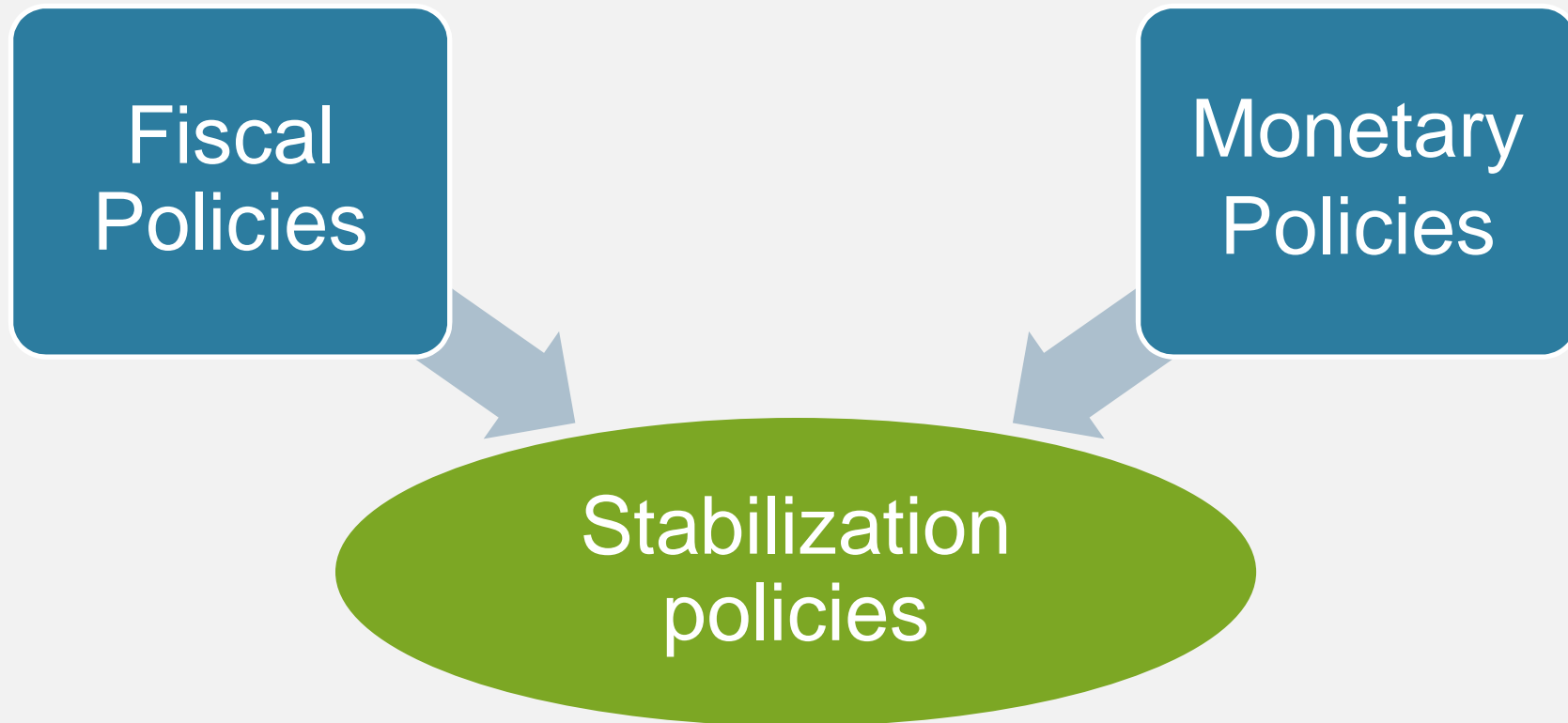
- Unemployment
  - Level of joblessness among people actively seeking work in an economic system



# The Economic Environment

(LO 2-2)

- Managing the Canadian Economy



# The Technological Environment

(LO 2-3)

- Technology
  - Includes all the ways a company creates value for its customers
    - human knowledge, work methods, physical equipment, etc.
- Research and Development (R&D)
  - Provides new ideas for products services and processes
    - basic
    - applied

# The Technological Environment

(LO 2-3)

## Product and Service Technologies

- Process Technologies:
  - used to improve a firm's performance of its internal operations
- Enterprise Resource Planning (ERP)
  - a large-scale information system for organizing and managing a firm's processes across product lines, departments and geographic locations

# The Technological Environment

(LO 2-3)

## ERP Applications

- Supply-chain management
  - forecasting, purchasing, distribution
- Accounting and Finance
  - accounts payable and receivable, asset management
- Manufacturing
  - material requirements planning, scheduling



# The Political-Legal Environment

(LO 2-4)

- Reflects the relationship between business and government (e.g., regulations)
  - pro- or anti-business sentiment
    - Canada's federal government has put a halt to bank mergers
  - political stability
  - international relations

# The Socio-Cultural Environment

(LO 2-5)

- Customs, values, attitudes and demographic characteristics of the society in which an organization functions
- Customer preferences and tastes
  - vary across and within national boundaries
  - vary within the same country
- Ethical compliance and responsible business behaviour

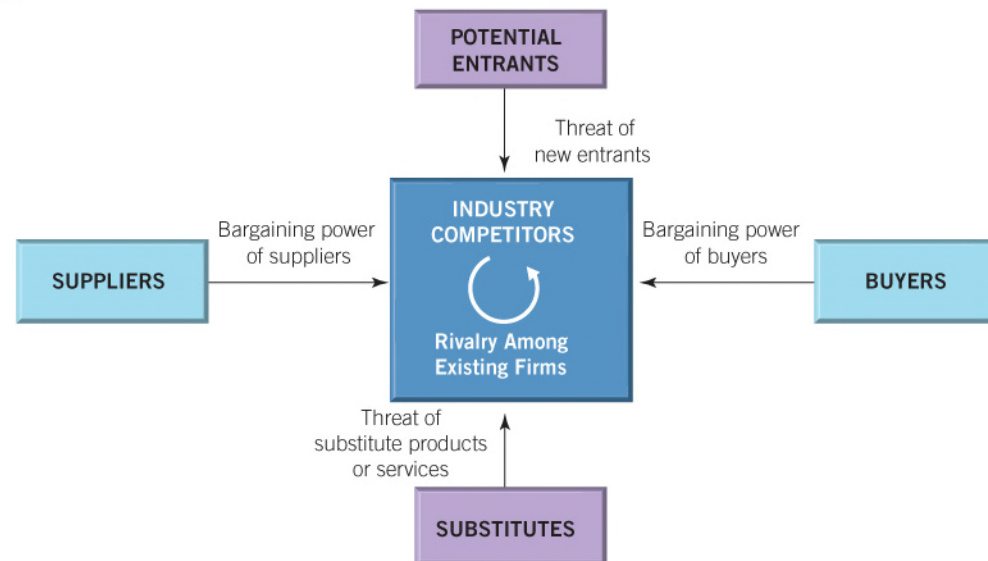
# The Business Environment

(LO 2-6)

- The Industry Environment
  - Porter's five forces model is used to analyze the competitive situation in an industry.

FIGURE 2.7

Michael Porter's five forces model.



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# The Business Environment

(LO 2-6)

## Emerging Challenges and Opportunities in the Business Environment

- The most successful firms are getting leaner by focusing on their *core competencies*
  - the skills and resources with which an organization competes best and creates the most value for owners

# The Business Environment

(LO 2-6)

- Outsourcing
  - paying suppliers and distributors to perform certain business processes
- Viral Marketing
  - using the Internet and word-of-mouth marketing to spread product information
- Business Process Management
  - moving away from department-oriented organizations toward process-oriented teams

# Redrawing Corporate Boundaries

(LO 2-7)

- Acquisitions and Mergers
  - horizontal, vertical or conglomerate mergers
  - friendly or hostile takeovers
- Divestitures and Spinoffs
  - selling part of existing business or setting it up as a new corporation

# Redrawing Corporate Boundaries

(LO 2-7)

- Employee-Owned Corporations
  - employee stock ownership programs (ESOP)
- Strategic Alliances
  - two or more companies temporarily join forces
  - often called a *joint venture*

# Redrawing Corporate Boundaries

(LO 2-7)

- Subsidiary and Parent Corporations
  - subsidiary corporation owned by another corporation
  - parent corporations own subsidiary corporations