

Chapter Four:

Environmental Analysis

Chapter outline:

- *The nature of external audit*
- *Sources of external information*
- *Forecasting tools and techniques*
- *Competitive analysis: Porter's five forces model*

Introduction

An *external audit* focuses on identifying and evaluating trends and events beyond the control of a single firm, such as increased foreign competition, population shifts to the Sunbelt, an aging society, information technology, and the computer revolution. An external audit reveals key opportunities and threats confronting an organization so that managers can formulate strategies to take advantage of the opportunities and avoid or reduce the impact of threats.

1.1 The nature of external audit

The purpose of an external audit is to develop a finite list of opportunities that could benefit a firm and threats that should be avoided. As the term *finite* suggests, the external audit is not aimed at developing an exhaustive list of every possible factor that could influence the business; rather, it is aimed at identifying key variables that offer actionable responses. Firms should be able to respond either offensively or defensively to the factors by formulating strategies that take advantage of external opportunities or that minimize the impact of potential threats

The Process of Performing an External Audit

The process of performing an external audit must involve as many managers and employees as possible. To perform an external audit, a company first must gather *competitive intelligence* and information about social, cultural, demographic, environmental, economic, political, legal, governmental, and technological trends. Individuals can be asked to monitor various sources of information such as key magazines, trade journals, and newspapers. These persons can submit periodic scanning reports to a committee of managers charged with performing the external audit. This approach provides a continuous stream of timely strategic information and involves many individuals in the external-audit process.

Once information is gathered, it should be assimilated and evaluated. A meeting or series of meetings of managers is needed to collectively identify the most important opportunities and threats facing the firm. These key external factors should be listed above. A prioritized list of these factors could be obtained by requesting all managers to rank the factors identified, from 1 for the most important opportunity/threat to 20 for the least important opportunity/threat. These key external factors can vary over time and by industry. Relationships with suppliers or distributors are often a critical success factor.

Freund emphasized that these key external factors should be:

- ➡ Important to achieving long-term and annual objectives,
- ➡ Measurable,
- ➡ Applicable to all competing firms, and
- ➡ Hierarchical in the sense that some will pertain to the overall company and others will be more narrowly focused on functional or divisional areas.

A final list of the most important key external factors should be communicated and distributed widely in the organization.

Key External Forces

External forces can be divided into five broad categories:

1. *Economic forces;*
2. *Social, cultural, demographic, and environmental forces;*
3. *Political, governmental, and legal forces;*
4. *Technological forces; and*
5. *Competitive forces.*

➡ **Economic Forces**

Economic factors have a direct impact on the potential attractiveness of various strategies. For example, as interest rates rise, then funds needed for capital expansion become more costly or unavailable. Also, as interest rates rise, discretionary income declines, and the demand for discretionary goods falls. As stock prices increase, the desirability of equity as a source of capital for market development increases. Also, as the market rises, consumer and business wealth expands. Price fluctuation refers to general price fluctuation. They affect the economic factors and affect the customers buying behaviors.

The customers are more conscious about the economic changes and responds according to the changes in key variable factors. So, any change in the price affects the customer buying trend directly.

Monetary policies and Fiscal policies are changed every year. The person or businesses engaged in business for profit making or non profit organizations always have to keep an eye on the economic structure of the countries.

As far as the tax rates are concerned, government also changes the tax rate with the passage of time. So it affects the economic forces.

It is important to monitor key economic factors such as:

- ➡ Foreign countries' economic conditions
- ➡ Import/export factors
- ➡ Demand shifts for goods/services
- ➡ Income differences by region/customer
- ➡ Price fluctuations
- ➡ Exportation of labor & capital
- ➡ Monetary policies
- ➡ Fiscal policies
- ➡ Tax rates etc.

A summary of economic variables that often represent opportunities and threats for organizations is provided in Table given below.

Key Economic Variables to Be Monitored

- Shift to a service economy in the United States
- Availability of credit
- Level of disposable income
- Propensity of people to spend
- Interest rates
- Inflation rates
- Money market rates
- Federal government budget deficits
- Gross domestic product trend
- Consumption patterns
- Unemployment trends
- Worker productivity levels
- Value of the dollar in world markets
- Stock market trends
- Foreign countries' economic conditions
- Import/export factors
- Demand shifts for different categories of goods and services
- Income differences by region and consumer groups
- Price fluctuations
- Exportation of labor and capital from the United States
- Monetary policies
- Fiscal policies
- Tax rates
- European Economic Community (ECC) policies
- Organization of Petroleum Exporting Countries (OPEC) policies
- Coalitions of Lesser Developed Countries (LDC) policies

➡ Social, Cultural, Demographic, and Environmental Forces

Social, cultural, demographic, and environmental changes have a major impact upon virtually all products (Preferences change), services, markets, and customers. Small, large, for-profit, and nonprofit organizations in all industries are being staggered and challenged by the opportunities and threats arising from changes in social, cultural, demographic, and environmental variables. We may use the following analysis in understanding the Social, Cultural, Demographic, and Environmental Forces:

- ➡ Population growing older
- ➡ Increase in younger population
- ➡ Ethnic balance changing
- ➡ Gap between rich and poor widening

Ethnic balance changes due to the migration of the people from different areas to different areas. This affects the ethical behavior very much. As the traditions and norms are very much different in different areas, therefore the behavior of the migrated people also have a major affect on the behavior of the resident people. Due to the *increased gap between rich and the poor*, there is a tremendous change in the social behavior of the people.

A summary of important social, cultural, demographic, and environmental variables that represent opportunities or threats for virtually all organizations is given in Table below.

Key Social, Cultural, Demographic, and Environmental Variables	
<ul style="list-style-type: none"> • Childbearing rates • Number of special interest groups • Number of marriages • Number of divorces • Number of births • Number of deaths • Immigration and emigration rates • Social security programs • Life expectancy rates • Per capita income • Location of retailing, manufacturing, and service businesses • Attitudes toward business • Lifestyles • Traffic congestion • Inner-city environments • Average disposable income • Trust in government • Attitudes toward government • Attitudes toward work • Buying habits • Ethical concerns • Attitudes toward saving • Sex roles • Attitudes toward investing • Racial equality • Use of birth control • Average level of education 	<ul style="list-style-type: none"> • Government regulation • Attitudes toward retirement • Attitudes toward leisure time • Attitudes toward product quality • Attitudes toward customer service • Pollution control • Attitudes toward foreign peoples • Energy conservation • Social programs • Number of churches • Number of church members • Social responsibility • Attitudes toward careers • Population changes by race, age, sex, and level of affluence • Attitudes toward authority • Population changes by city, county, state, region, and country • Value placed on leisure time • Regional changes in tastes and preferences • Number of women and minority workers • Number of high school and college graduates by geographic area • Recycling • Waste management • Air pollution • Water pollution • Ozone depletion • Endangered species

➡ **Competitive Forces**

“Collection and evaluation of information on competitors is essential for successful strategy formulation” Competition in virtually all industries can be described as intense.

- ➡ Identifying rival firms: Strengths, Weaknesses, Capabilities, Opportunities, Threats, Objectives and Strategies

Key Questions about Competitors:

- ➡ Their strengths
- ➡ Their weaknesses
- ➡ Their objectives and strategies
- ➡ Their responses to all external variables (e.g. social, political, demographic, etc.)
- ➡ Their vulnerability to our alternative strategies
- ➡ Our vulnerability to successful strategic counterattack Our product and service positioning relative to competitors

□ Entry and exit of firms in the industry

- ✓ Key factors for our current position in industry
- ✓ Sales and profit rankings of competitors over time
- ✓ Nature of supplier and distributor relationships
- ✓ The threat of substitute products or services

Competitive Intelligence Programs

Systematic and ethical process for gathering and analyzing information about the competition's activities and general business trends to further a business' own goals.

Every organization must have an intelligence programmed. It should be ethical and systematic for gathering and analyzing the information about competitor activities and activities involve in general business

➡ **Political, Governmental, and Legal Forces**

Change in government regulations which create opportunities and threats. For example, antitrust legislation where there is an effort to ban the monopolies. Some organizations think that monopolies should be banned. Similarly, tax rates and lobbying efforts for special, lobbying entries are those efforts which are made in order to pass special resolution laws of their own choice. Patents law and intellectual are also relates to the same stories.

Federal, state, local, and foreign governments are major regulators, deregulators, subsidizers, employers, and customers of organizations. Political, governmental, and legal factors, therefore, can represent key opportunities or threats for both small and large organizations. For industries and firms that depend heavily on government contracts or subsidies, political forecasts can be the most important part of an external audit. Changes in patent laws, antitrust legislation, tax rates, and lobbying activities can affect firms significantly.

Impact of political variables on government regulations:

- ➡ Government regulation/deregulation
- ➡ Tax law changes
- ➡ Special tariffs
- ➡ Political Action Committees (PACs)
- ➡ Voter participation rates
- ➡ Number of patents
- ➡ Changes in patent laws

A summary of political, governmental, and legal variables that can represent key opportunities or threats to organizations is provided in Table below.

Some Political, Governmental, and Legal Variables	
<ul style="list-style-type: none"> • Government regulations or deregulations • Changes in tax laws • Special tariffs • Political action committees • Voter participation rates • Number, severity, and location of government protests • Number of patents • Changes in patent laws • Environmental protection laws • Level of defense expenditures • Legislation on equal employment • Level of government subsidies • Antitrust legislation 	<ul style="list-style-type: none"> • Sino-American relationships • Russian-American relationships • European-American relationships • African-American relationships • Import-export regulations • Government fiscal and monetary policy changes • Political conditions in foreign countries • Special local, state, and federal laws • Lobbying activities • Size of government budgets • World oil, currency, and labor markets • Location and severity of terrorist activities • Local, state, and national elections

➡ Technological forces

Technological forces represent major opportunities and threats that must be considered in formulating strategies. Technological advancements dramatically can affect organizations' products, services, markets, suppliers, distributors, competitors, customers, manufacturing processes, marketing practices, and competitive position. Technological advancements can create new markets, result in a proliferation of new and improved products, change the relative competitive cost positions in an industry, and render existing products and services obsolete. Technological changes can reduce or eliminate cost barriers between businesses, create shorter production runs, create shortages in technical skills, and result in changing values and expectations of employees, managers, and customers. Technological advancements can create new *competitive advantages* that are more powerful than existing advantages. No company or industry today is insulated against emerging technological developments. In high-tech industries identification and evaluation of key technological opportunities and threats can be the most important part of the external strategic management audit.

Organizations that traditionally have limited technology expenditures to what they can fund after meeting marketing and financial requirements urgently need a reversal in thinking. The pace of technological change is increasing and literally wiping out businesses every day. An emerging consensus holds that technology management is one of the key responsibilities of strategists. Firms should pursue strategies that take advantage of technological opportunities to achieve sustainable, competitive advantages in the marketplace.

4.2. Sources of external information

A wealth of strategic information is available to organizations from both published and unpublished sources. Unpublished sources include customer surveys, market research, and speech at professionals and shareholders' meetings, Television programs, interviews, and conversations and stakeholders. Published sources of strategic information include periodicals, journals, reports, government documents, abstracts, books, directories, newspapers and manual. The Internet provides another source for gathering strategic information, as do corporate, university, and public libraries. Suppliers, distributors, salespersons, customers, and competitors represent other sources of vital information.

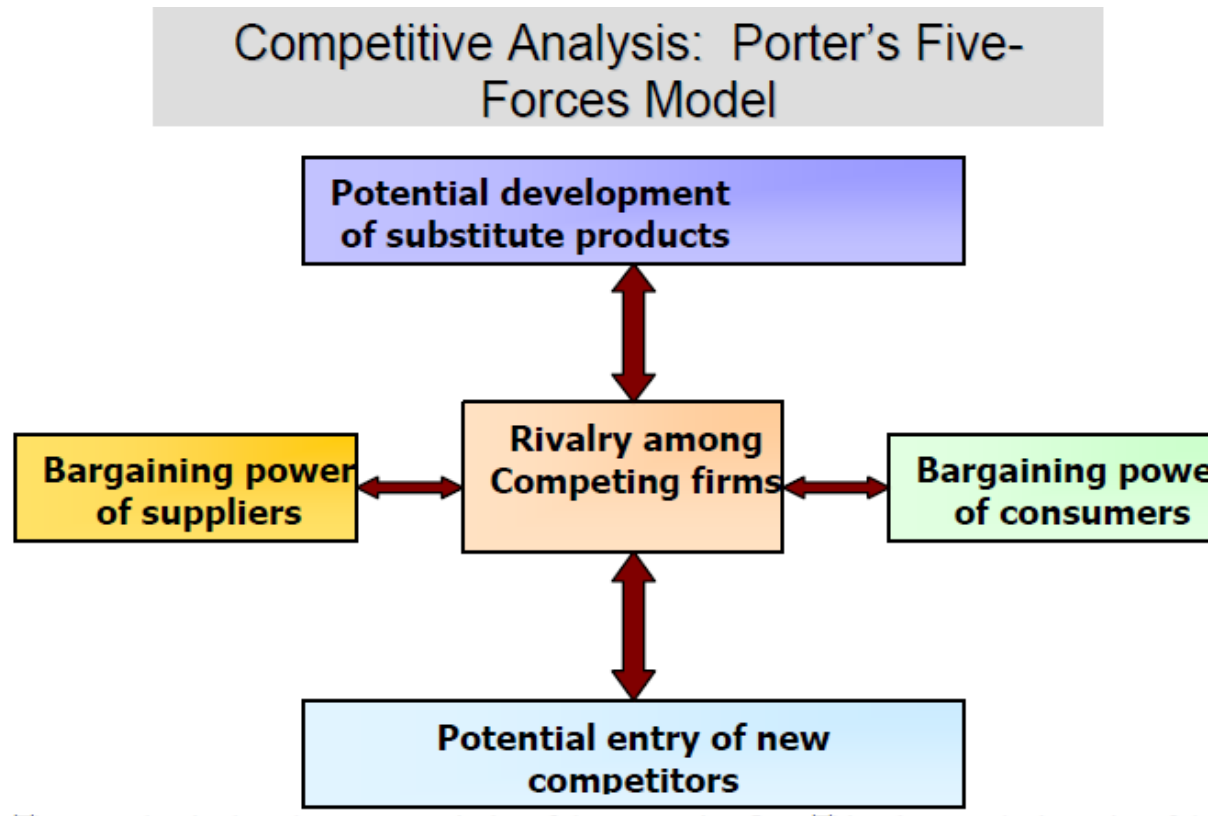
4.3.Forecasting tools and techniques

Forecasts are educated assumptions about future trends and events. Forecasting is a complex activity because of factors such as technological innovation, cultural changes, new products, improved services, stronger competitors, and shifts in government priorities, social values, unstable economic conditions, and unforeseen events. Managers often must rely upon published forecasts to identify key external opportunities and threats effectively.

Forecasting tools can be broadly categorized in to two groups: Quantitative techniques and qualitative techniques. Quantitative forecasts are most appropriate when historical data are available and when the relationships among key variables are expected to remain the same in the future.

No forecast is perfect, and some forecasts are even wildly inaccurate. This fact accents the need for strategists to devote sufficient time and effort to study the underlying bases for published forecasts and to develop internal forecasts of their own. Key external opportunities and threats can be effectively identified only through good forecasts. Accurate forecasts can provide major competitive advantages for organizations. Forecasts are vital to the strategic-management process and to the success of organizations.

4.4 Competitive analysis: Porter's five forces model



The central point lays the stress on rivalry of the competing firm. This relates to the intensity of the rivalry. How the firms compete with each other and to what extent? That should be taken into account very carefully. Potential entry for new competitors shows a balance between different firms competing in a market. It also refers whenever a new partner enter into a market he may become threat for one and opportunity for other competing partners. As all the new entries and existing firms are competing with each other so the new entry will definitely make an effect on every one transacting in the market.

A potential development of substitute products also develops an environment of competition in the market among the competing partners. As all firms want to compete in term of quality and substitute will lasts for longer in the market if the quality of the substitute will be greater than the existing alternate. Other factors also have a major impact on the substitutes.

Collective bargaining power of suppliers and consumers: if vendors are less in the market and the organizations that have to purchase from those vendors are more then the demand for those suppliers will be more as the firms have to purchase from that less suppliers. The reverse is the case if suppliers are more and buyers are less. Then the demand for those suppliers will be less. Such circumstances create difficulties in bargaining.