

How the External Environment Can Affect Costs and Demand

Commercial organisations function in an external environment subject to various and rapidly changing components. In order to be sustainable, businesses need to be resilient to external forces – even when these are working against their interests. Implications differ depending on the business' specifications – such as its composition and the environment in which it operates. This course will help you understand how the external environment can affect costs and demand using methodologies reputed among scholars. Questions at the end will help you to assimilate these principles.

I. I. PESTEL: Understanding the External Environment of a Business

Due to market diversity and constant changes, it can be challenging for entrepreneurs and business owners to fully understand the environment in which they operate or plan to do business. One of the most common tools used to assess most of the external factors – i.e. the factors out of the control of the firm – having an impact on its operation is the PESTEL analysis.

1. PESTEL Analysis: broad definition

The PESTEL analysis method allows a better understanding of a firm's business environment by owners and directors; it also permits them to make better decisions based on collected data. Also, it provides with valuable information about current issues and future risks that the

company will have to face. The PESTEL acronym stands for Political, Economic, Social, Technology, Environmental and Legal. In order to fully understand their specificities and interactions with each other, analysts often divide these categories into 3 groups that will be discussed in the following sections: Technological & Social, Political and Legal, Economic & Environmental.

2. Technology & Social changes

The technology category deals with aspects of the external and internal environments in regard to new industrial processes, technologies and breakthroughs. Technological advances susceptible to create new opportunities for entrepreneurs can influence the way companies do business – e.g. R&D in and out of the company. The technological factor became increasingly important over-time as new processes, products and services stimulated innovation around the world, permitting businesses to profit from new markets. In fact, new communication means for instance contributed to the rapid expansion of international trade. Also, new technologies might have an impact on working practices such as demonstrated during the industrial revolution – e.g. the assembly line process.

The social factor constitutes all the components linked to cultural aspects (e.g. traditions and religions) and demographic trends – current and projected. Therefore, it includes a wide variety of elements which can have an impact on businesses – relevant elements might change from one firm to another. The important point to notice is that all of these factors could change over-time, and thus, need to be taken into consideration by directors when planning – the composition of demographics might change rapidly in terms of age, education or ethnicity for example.

3. Political & Legal Implications

The political aspect includes all the implications of local and governmental diplomacy – i.e. the firm's interaction with officials and governmental institutions. It also comprises the current and

future political stability and fiscal policies of a country. A more forward definition for this section would include all the manners a government's policies can impact trading practices.

The legal considerations encompass all of the judicial elements that can possibly affect the company's way of operating. They include the production, distribution and marketing of all of its products and services. The implications are therefore considerable since every aspect of corporate governance is subject to the authority of the governing institution.

4. Economic & Environmental issues

The economic factor contains variables about the mercantile and industrial condition of a country or region by looking at its fundamental industries. It includes indicators such as its growth rate, inflation, interest rates and the value of its currency – these are the most important measures economically relevant. In other words, it takes into account all of the macroeconomic variables – i.e. functions linked to a country's economic performance, organisation and comportment.

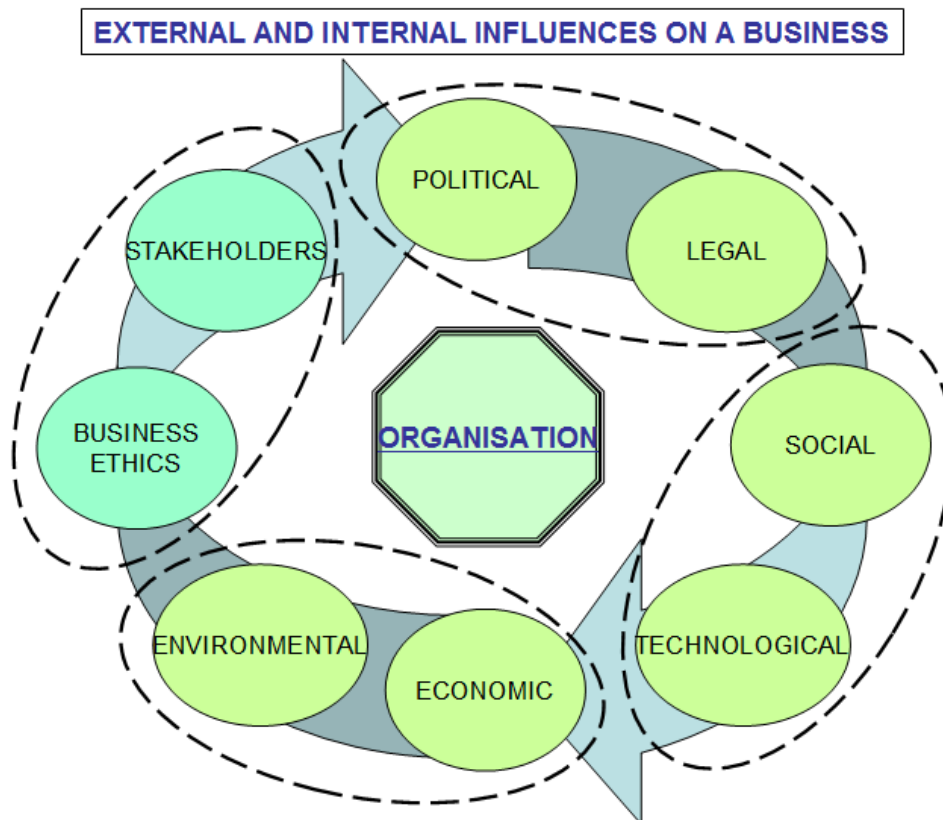
The environmental section takes into account all the elements associated with ecological issues such as air pollution, water processing, fair treatment of animals and so on. It is greatly influenced by political and legal factors which can impose restrictions and quotas in regard to the impact of companies on the fauna and flora. While technological advancements provide new means to deal with the problems encountered, they also provide entrepreneurs with new market opportunities.

II. Effects on Costs and Demand

The analysis of the impact of the external environment on costs and demand requires the consideration of its major internal influences. That is, the factors that are determined by the internal elements of an organisation.

1. External Vs. internal factors

While PESTLE analysis outlines the external factors affecting a company's operations, it is important to point out the two major internal elements of an organisation that are the most closely related to its environment: stakeholders and business ethics.



Stakeholders consist of all the parties with a vested interest in an organisation – e.g. shareholders, customers, employees, managers, suppliers and communities. While each group's type of interest differs, they set common corporate goals and objective in order to spread the benefits accordingly to preferences – e.g. a factory investing in green technologies might satisfy:

- Communities and regulators– due to lower pollution levels;
- Employees and managers – for the pride they get from working in a valued and respected institution;
- Shareholders – could benefit from lower operating costs and a better reputation.

Business ethics is an internal factor that combines elements such as corporate values, corporate responsibility and beliefs. It establishes rules and moral codes for the conduct of its operations. This category is subject to different interpretations and could create tensions among stakeholders.

2. Effects of the external environment on Costs and Demand

In regard to costs and demand, on one hand, new technologies permit to dramatically boost business sales; this is due to a seemingly ever increasing demand for new products worldwide – particularly for high-tech products since the last quarter of the 20th century. It also allows businesses to reduce their production costs thanks to new and more efficient communication means, equipment and processes.

On the other hand, social trends affect the way people consume; businesses need to pay close attention to changes in the environment of their customers. Also, competition could take an advantage due to new innovations within its internal structure – e.g. in R&D

departments. Moreover, while the impact on costs varies, new social behaviour could indirectly terminate an industry and/or create a new one by affecting demand levels.

Concerning the implications of politics on costs and demand, we can hardly establish a common rule to all businesses. In fact, depending on the territories in which they operate, political stability could vary considerably. Nevertheless, it is recognised that the more stable a country is, the lower the costs and the higher the demand for products and services. This is due to the fact that lower risks drive investment costs down and motivate individuals to consume more.

The effects of macroeconomic factors on businesses could be determining for its success or failure. Indeed, growing markets offer more opportunities to entrepreneurs while stagnating and receding markets could threaten most companies' sustainability. On the other hand, environmental issues could have an adverse effect on the costs of a business. In fact, companies could be convicted by a court for wrongdoing their environment whether directly or indirectly. However, the emergence of "green" technologies provide with alternatives profitable to the environment and to investors.

Worldwide, businesses are influenced in different degrees by both local and global constraints aimed at preserving the earth's sustainability. It can for instance, push businesses to invest more in ecological processes in order to reduce costs and better respond to more exigent consumers. Therefore, the thorough environmental scanning of a business is primordial to ensure an efficient and relevant decision-process for owners, investors and directors alike. We remarked in this course that the effects of external and internal factors could have a tremendous impact on demand and costs.

Multiple Choice Questions

1. Which statement is false about PESTEL?
 - a. It reveals current and potential future risks;
 - b. It gives a better understanding of a firm's business environment;
 - c. Owners and managers can make better decisions thanks to its analysis;
 - d. All false.

2. What does PESTEL stand for?
 - a. Acronym for Political, Economic, Social, Technology, Environmental and Legal;
 - b. Acronym for Public, Economic, Social, Technology, Environmental and Legal;
 - c. Acronym for Political, Economic, Social, Technology, Ethics and Legal;
 - d. Acronym for Political, Ecological, Social, Technology, Environmental and Legal.

3. What does the Social factor include in PESTEL?
 - a. Firm reputation and customer specificities;
 - b. Cultural influences and demographics;
 - c. Population age, education and ethnicity;
 - d. b. & c.

4. What is most fitting description for the Political category of PESTLE?
 - a. All of the judicial elements that can possibly affect the company's way of operating;
 - b. It is all the components linked to cultural aspects;
 - c. It is the different manners a government's policies can impact businesses;
 - d. a. & c.

5. What is the definition of macroeconomics?

- a. The study of a country's economic structural organisation as a whole;
- b. The study of a country's economic behaviour as a whole;
- c. The study of a country's economic performance as a whole;
- d. The study of a country's economic performance, structure and behaviour as a whole.

6. What are the major internal factors that influence a business?

- a. Political, Social, and Technological;
- b. Environmental, Social, and Economical;
- c. Stakeholders and Business Ethics;
- d. Economic, Political, and Business Ethics;

7. What is the composition of stakeholders?

- a. Customers, employees, and communities;
- b. Shareholders and managers only;
- c. Shareholders, managers, and suppliers;
- d. a & c

8. Which statements is (are) false?

- a. Demand for high-tech products since the last quarter of the 20th century has significantly increased;
- b. External and internal factors are constant over-time;
- c. Political stability of a country influences on consumer behaviour;
- d. Social trends affect the way people consume.

9. What is business ethics?

- a. An internal factor that includes corporate values, corporate responsibility and beliefs;

- b. An internal factor which establishes rules and codes of conducts of an organisation;
- c. An internal factor that does not affect costs and demand;
- d. a & b.

10. How does business ethics relate to stakeholders?

- a. It is completely independent;
- b. Stakeholders set the standards of business ethics;
- c. Business ethics defines stakeholders' values;
- d. a. & c.

Answers

1: d ; 2: a ; 3: d ; 4: c ; 5: d ; 6: c ; 7: d ; 8: b ; 9: d ; 10: b.