I Business Environment

Introduction

While one organization is restructuring its post room, another has invented a low-cost, low-emission alternative to hydrocarbon fuel. While one organization indicates a pending increase in local taxes, another patents a retroviral drug for an ‘incurable condition’, and yet another quells a public order situation in a major capital city. And while children starve in Africa, we launch probes to the planets in search for our homes and resources of the future . . .

However we see it, organizations of just about every type – no matter what their global significance, or how they differ in detail – are concerned with transforming inputs to outputs. They do this against a backdrop which readily affects – and in turn is affected by – the conduct of their activities. This backdrop is the ‘business environment’, one that is increasingly complex, dynamic and volatile. As an (anonymous) delegate on one of our recent auditor training courses said:

. . . change is the only constant these days . . .

If we are able to understand this business environment and the possible or likely effects it might have upon organizations, it will not only assist us in understanding the practice of ‘business’ in its entirety but will help auditors in their functioning as well.

As you will see, auditing is about providing a confirmation (or an assurance) that an organization has reasonably addressed foreseeable risks towards the achievement of its business objectives within a suitable framework for internal control. Along with providing assurance for the present, it also involves assessing its suitability for the business environment in the future. Information about future prospects is much more valuable to managers than information about the present or past.

This chapter takes us on a short journey through the key elements of understanding business environments, before moving on to summarize the role of managers in positioning their organizations for success, and finally answers the question ‘what is risk?’

Beyond PEST

As any management student or management textbook will affirm, there are numerous tools and techniques available for gathering and analysing the results of a review
of external environments. A common tool is ‘PEST’ (and its derivatives) as noted below:

- PEST (Political, Economic, Social, Technical),
- PESTEL (same as in PEST + Environmental, Legal),
- PEST-CM (same as in PEST + Customers, Markets), and
- STEEP (Social, Technical, Economic, Environmental, Political).

While all these recording tools can be helpful, in this chapter we will focus on some of the key features to be understood, and offer a simple format for recording both, internal and external features.

The simple tool for recording the significant internal and external environmental features applicable to an organization is a SWOT analysis – strengths, weaknesses, opportunities and threats. Strengths (S) and weaknesses (W) are internally focused, while the opportunities (O) and threats (T) are external to the organization. A basic format for this is shown in Figure 1.1:

**The business environment**

As stated earlier, in this chapter we will look at external and internal environments relevant to all organizations, and later examine four distinct areas of essential knowledge in the environmental context:

- political,
- economic,
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- legal, and
- resources.

The four major areas mentioned are summarized here and readers are referred to the bibliography for further details.

The external environment – an overview

Look around. Business activity surrounds us. It is everywhere, starting each morning with the delivery of the morning newspapers, and with generation and distribution of the electricity we use to heat water for breakfast tea. ‘Business’ per se is however quite difficult to exactly categorize – it probably concerns all activities of trade (buying and selling), profit (making one, or existing not-for-profit), provision of service (whether governmental, charitable, religious or other) and many others.

Definition of ‘Business’ – Occupation; concern; trade. Pertaining to traffic; trade.

– Castle English Dictionary.

Here, we take the broadest possible view of the term, and encourage readers to think of ‘business activity’ as it concerns their own undertakings, or organizations known to them.

Business has only two basic functions – marketing and innovation.

– Peter Drucker.

Organizations have inputs (from our given example, newspapers, coal or gas, public donations), some process or activity adding value (manufacturing, delivery, conversion), and finally an output (the good or service, and its waste). The common feature of all organizations is the transformation of inputs to outputs. This is summarized in Figure 1.2.

Simply put, organizations of all types require land, labour and capital resources – classically known as the ‘factors of production’ by economists. Specifically, organizations require talented people with great ideas, a source of financial support for the enterprise, suitable buildings/accommodation for the process or activity, a supply of materials, committed workers, satisfied customers, and so on.

In accordance with the anticipated needs of their target consumers, these are combined to deliver the planned output (goods, services, information, etc.). In successful organizations, this is a cyclical activity as shown in Figure 1.2. The generation of an output which is consumed by the customers generates revenue or appetite for the acquisition of new inputs, and a reward, whether financial or other, for the financiers.
Let us relate this to a couple of simple scenarios:

1. A corner shop
   An entrepreneur, backed by a bank or parents, purchases premises and stock. The entrepreneur hires staff, and advertises the opening of the shop and its unique selling points (e.g. that it is convenient, local, etc.). Customers visit and make purchases. With the revenue, the entrepreneur purchases new stock to replace that sold, and makes the agreed loan payments to the bank, or reimburses the parents. If the entrepreneur has planned wisely, there may be a small profit as a reward, which will be re-invested elsewhere in the economy (e.g. purchases, savings, etc.).

2. A charity
   A registered charity seeks to raise disaster-relief funds. It hires premises, engages staff for a call-receiving centre, and advertises a need for donations. Donations are made, and these are divided to pay for the premises, staff wages and advertising; the excess will be donated to relieve suffering in the disaster zone. If the charity has planned wisely, this remainder will be sufficiently large to allow further advertising, based on the success of the initial phase. Again, staff salaries will be inputs elsewhere in the economy.

A-Factor 1: Organizations are concerned with transforming inputs to outputs. Inputs create outputs, and outputs create inputs.

**Business organizations in their environment**

These simple models mentioned are, of course, much more complicated in the operational reality of business and commerce in action. Organizations are inseparably intertwined with their outside world – the external environment.

This business environment, where all organizations conduct their enterprises, comprises a wide range of influences. These include:
1. the prevailing political climate; the macroeconomic situation; the legal framework; technological, educational, entertainment and sport; religion and organized crime (sociocultural); and

2. the availability of resources (scarcity), willingness of potential customers to trade, and the activities of any competitors.

The factors in the former group tend to have a slowly developing and general influence upon the enterprise whereas the ones in the latter group represent the day-to-day/operational influences.

**General influences**

These factors are discussed later in this chapter, but a short overview is provided here by highlighting some of the key external influences on businesses:

**Politics**

Different types of governments have different political aspirations, and manipulate economies to these ends. This manipulation will tend to influence the business environment. For example, in the early years of the twenty-first century, in Europe, there seems to be a significant political aspiration to combine national trading into an international trading block called the European Union. Governments are generally large organizations, and employers of large numbers of people.

**Macroeconomics**

Governments create (and sometimes destroy) macroeconomic climates conducive to investment. Policies to create high or low levels of public sector borrowing, higher or lower levels of employment, higher or lower levels of inflation are examples of how governments intervene. Fiscal policies release (or withdraw) public sector spending, and other policies promote (or discourage) the creation of jobs.

**Legal**

In all countries there is a framework of laws and regulations – well-developed or not – that defines the relationships between the state, organizations and individual citizens. In some territories, for example in the United States of America (USA/US), there is an interrelationship between local (state) laws and national (federal) laws. Similarly in Europe, an implementation of many legal requirements is from federal level (EU directives) to country level (domestic legislation). Like the macroeconomic climate, this can be viewed as connected to the political perspective.

**Sociocultural**

Demand and thus supply is driven by social and cultural factors. The demand for electronic goods increases where homes have electricity. The supply of locally produced textiles reduces when markets move overseas to take advantage of lower labour rates.
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Technology
It seems the speed of technological advance in the twenty-first century is near-exponential, as anyone who has purchased a new television or computer recently may have noted. The willingness of organizations to invest in new technologies depends upon their attitudes to the external market, but is generally seen as a key to the success of an enterprise (or a country) over its peers.

Day-to-day/operational influences

Resources
Organizations rely upon their suppliers for resources. Likewise, the success of a supplier organization is sometimes dependant upon its customer; the operation of the two organizations has become intertwined. Organizations must tend to contracts, pricing agreements, delivery lead times and contingencies as a part of the continuity from input to output. Charles Handy, in *The Empty Raincoat* (1994) introduces the concept of the ‘Chinese contract’. This concerns a finely balanced agreement between two parties, where neither is advantaged or disadvantaged to the cost of the other.

Customers
Of course, customers are vital to all organizations and employees – customers make paydays possible! An ability to meet/exceed current requirements (and to anticipate future requirements) for price, quality and delivery on time are the hallmarks of successful organizations. ‘The customer is king’ is proclaimed aloud by many organizations, whilst ‘customers get in the way of the real work’ may be whispered in the offices. Markets for products, services and information are becoming increasingly market-led, and organizing a business to satisfy the emerging needs of customers remains a vital requirement.

We particularly like the metaphor that is expressed in *Who Moved My Cheese* by Johnson (1999). It concerns a nimbleness and adaptation to a customer-base that we have tried to apply to our own organizations. An enlightening read!

Competitors
‘Winning’ and ‘losing’ in commercial environments often concerns one party’s performance relative to another’s. This ‘other’ is one or more competitors who may desire to provide customers with lower-cost, higher-quality, or differentiated goods and services. Competition from overseas, where overheads may be lower, may be seen as particularly ‘unfair’. Innovation by competitors can render competing products and services obsolete. How an organization responds to its competitors (e.g. deciding upon the time for aggressive product development or defensive pricing) may be a significant indicator of its future success in its field of operation.

A-Factor 2: Organizations are inseparably intertwined with their external environment. Their managers should take account of this to achieve their organizations’ objectives.
The internal environment

Organizations decide how to operate in order to meet their objectives. A common theme running through any analysis of internal environments is ‘management’ and the style of its conduct. Management concerns both, the roles fulfilled by the individuals who manage an enterprise, and the process – the management system – by which the enterprise sets out to meet its objectives. At this stage, we should stress upon the interaction between internal and external environments. If an enterprise is to remain successful, attention needs to be paid by the senior managers to balance all of the competing environmental influences by adapting so as to cope with the new circumstances facing the organization, and then being ready to institute further changes as and when required.

Case study

A large, UK-based entertainment organization has approximately 250 clubs providing evening entertainment and dancing. A cursory review of its business environment highlights the following features to be managed if business objectives are to be met. Externally, an extension to licensing hours, a pending ban on smoking in pubs and clubs, a focus on noise exposure levels, increased use of illegal substances, media focus on late-night town-centre disorder, and a rise in underage drinking. Internally, the retention of key staff as they progress with age, marriage and family from ‘happy to work at night’ to finding working at night less acceptable. Some parts of the business are for sale, and maintaining staff morale could be challenging.

Organization and management

There are three main categories of organizational theory:

- classic,
- HR approach, and
- systems-based.

Classic

Writers such as F.W. Taylor (1856–1915) viewed organizations as formal structures established to achieve objectives under the direction of top management. Taylor believed that management was responsible for ‘scientific management’ – methods attached to the design of work, such as work study, that could be applied to heighten production.
HR approach

An alternative approach to the classic, formal organization is the HR approach which emphasizes the importance of people in workplaces. The famous Hawthorne Experiments (1924–1932), conducted in USA, showed that individuals at work were part of informal as well as formal structures, and that group influences were fundamental to understanding individual behaviours. Thus influencing human behaviour becomes critical to enhancing the effectiveness of organizations.

Systems-based

The approach, described earlier, of converting inputs to outputs and outputs to inputs (along with all the associated subsystems) produces a systems-based organizational theory. Modern views of organizations focus on such ‘systems-based’ approaches, where management is a highly critical subsystem directing the enterprise towards its objectives. Some of these ‘management systems’ are externally certified, such as ‘Investors in People’ in the UK, or ISO 14001:2004 internationally.

Whichever the organizational theory preferred, an organizational structure to deliver it in practice is desirable.

Organization structures

In all organizations – even sole traders, where the spouse may assist with the financial books – there is a division of effort in pursuit of the objectives. This resultant pattern of relationships is commonly known as the organization structure. This structure provides the means by which the work is planned, communicated, carried out and supervised.

A main feature of all organization structures is that they embed a hierarchy within them, as Figure 1.3 shows:

Within organizational structures, there are five main approaches:

- by product/service,
- by geographical location,
- functional,
- matrix organization/project team, and
- virtual.
By product/service

For example, a High Street store may have the following departments, each with specialist staff, to focus on the needs of customers – the structure follows the sales process.

- menswear,
- ladies wear,
- home and garden, and
- grocery.

By geographical location

For example, a double-glazing company may structure regionally (North, South, East, West of territory/country) to provide a local address to customers, and employ locally based management and staff.

Functional

For example, a manufacturing organization may structure functionally – the structure follows the activity of the enterprise.

- procurement/goods in,
- production,
- warehouse,
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- sales and marketing, and
- personnel/HR.

Matrix organization/project team

For instance, a Grand Prix motor race takes place each year at a national venue e.g. the Circuit de Catalunya on the northern outskirts of Barcelona, Spain. A project team is brought together to combine in a matrix the skills of the full-time race management team with local suppliers of accommodation, ticketing, catering, parking, waste disposal and so on. It is disbanded after the event, until perhaps brought together again for next year’s event.

Virtual

For example, an online auction relies upon a loosely connected web of member buyers, sellers and advertisers to achieve its business objectives – a formal organization chart is virtually invisible.

In reality, some of the characteristics of each of these organizational structures may be present in a single organization to meet its current needs.

A-Factor 3: The structure of an organization is a means to an end, not an end in itself.

The external environment in detail

The political environment

Business activity takes place locally, within countries, across borders and internationally. It is inevitable that governments will be involved in some way. Markets are globalizing for many products and services because governments around the world are taking action to remove barriers to trade. Understanding the basics of political systems, institutions and processes provides greater opportunities for organizations to align themselves, and thus provide greater opportunities for achieving business objectives.

Politics

A good question for audit practitioners reading this book is ‘what is politics?’ An attempt is made to answer that question from that perspective.

The style and nature of any country’s political system will tend to be underpinned by its historical and social values, national identity and political philosophies. Revolutions
come and go but political evolution is the norm – incremental, rather than radical – particularly in democratic countries. This tends to bring some degree of stability to the business environment, particularly in developed countries.

The two extremes of political systems are:

- totalitarian and
- democratic

**Totalitarian**
Arising from the power of monarchy, from military conquest (sometimes called a ‘junta’), or a free election, a totalitarian government will tend to act in order to restrict or prohibit political participation by others. The style of government tends to be a rigid enforcement of rules and oppression of opposition.

**Democratic**
Exemplified by free and fair regular elections, and freedoms of speech and media, democratic systems provide more balanced governments where matters are discussed, and solutions accepted by all participants, even if they disagreed in the first place.

A model for democratic government is shown in Figure 1.4.

To be recognized as a democratic government, more is needed than a transparent election process. It should provide that the wishes of the electorate, in terms of the majority according to the votes cast, are reflected in the final result.

This point can provide for interesting debate between political purists where, for example, a ‘first-past-the-post’ system is in place. In the UK, for instance, a simple majority of votes over other candidates is needed to be considered ‘elected’ in a regional constituency. At national level, a simple majority of candidates elected over other political groups (or parties) is needed to be asked by the Queen to form

![Diagram](image-url)  
**Figure 1.4** Model for democratic government
a government in a representative assembly. As a result, it is often the case that
the winner has less than 50 per cent of the total votes cast. Alternatives to this
approach include ‘proportional representation’, where the electorate can indicate its
second and, sometimes further, wishes for votes to be recast if there is no outright
winner. Overall, a first-past-the-post system tends to produce majority government,
and proportional representation tends to produce coalition government. Majority
governments tend to implement their manifesto (the pre-election sales pitch to the
electorate) and coalition governments tend to develop laws through negotiation and
compromise with their government partners.

Functions of government

The process of governing a country involves three main roles – making decisions,
implementing those decisions, and enforcing compliance through a system of courts:

- law maker,
- law implementer, and
- law enforcer.

Law maker

Governing involves taking major decisions that may affect the lives and environments
of individuals and organizations. Elected governments in a democratic system hold
the power to make the law, and there is usually a series of checks and balances
including a bicameral legislature (i.e. an Upper House and a Lower House) and other
established processes to ensure that this is fair.

Law implementer

The government holds responsibility for putting laws into effect. The day-to-day
administration is carried out by non-elected officials called civil servants, whose major
role is implementing public policy. While politicians may come and go, civil servants
are permanent career positions. They are expected to act in a non-partisan way, and
this allows for continuity of governance, for example, when one government loses
power to the next.

Law enforcer

The third arm of a government is a judiciary and system of courts. It is a hallmark
democratic systems that there be separation between the law enforcement role of
‘the judiciary’ and the other two main functions. An independent judicial system,
free and able to challenge the government and review its decisions, provides a further
check and balance to a democratic government – and it protects citizens from a state
that has become too powerful.

Auditors need an appreciation of how political factors can impact upon auditees – for
example, how laws are initiated, developed, implemented and enforced. A review of
legal compliance will be necessary in a number of auditing assignments.
Trans-frontier government

As noted earlier, political influences are not restricted to national boundaries. International groupings such as the Group of Eight (G8) (formerly the Group of Six (G6) and the Group of Seven (G7)), the World Trade Organisation (WTO) and the European Union (EU) add far-reaching dynamics to an external environment with an increasingly profound influence.

G8
The USA, Japan, Germany, France, Italy, Canada, Russia and the United Kingdom (UK) (together representing 66.5 per cent of the world’s economy) meet regularly to discuss matters of mutual interest. Known as ‘economic summits’, these attract significant interest from protestors and media alike.

WTO
The World Trade Organisation was formed in 1995 to supersede the General Agreement on Tariffs and Trade (GATT), which had been formed in 1947 to assist with re-establishing trade at the end of the Second World War. With a large membership – and many other countries indicating that they wish to join – the WTO is credited with opening up global trading within a framework of agreed rules.

EU
The EU is (in 2006) a group of twenty-five European nations. It was founded in 1958 by the Treaty of Rome with six original members (West Germany, France, Italy, Holland, Belgium and Luxembourg). Progressive enlargement in 1972 (UK, Denmark, Eire), 1981 (Greece), 1986 (Spain and Portugal) and 1995 (Austria, Finland, Sweden) was further magnified on 1 May 2004 when ten new members were admitted (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia).

Bulgaria and Romania may become members of the European Union in January 2007. In December 2004, the European Council decided that in the light of a European Parliament resolution, Turkey had sufficiently fulfilled the Copenhagen criteria to open accession negotiations.

The aim of the founding Treaty of Rome was to create a common market to promote trade, and bring national economies closer together. This convergence led towards the creation of a single market, when the members signed the Single European Act, effective 31 December 1992, comprising the following features:

• reduction in legal and other obstacles to cross-border travel and trade,
• harmonization of technical/safety standards,
• convergence of excise duties, and
• mutual recognition of qualifications.
Other treaty provisions provide for:

- monetary union, which was achieved in eleven member countries on 1 January 1999,
- a social chapter to protect workers (including their health and safety), and
- common foreign and security policies.

Time will tell when and whether further countries will adopt/be permitted to adopt the Euro as their common currency.

To put in place such a significant series of changes, literally hundreds of new laws and regulations have been required in the member states. For completeness, a very briefly summary of the architecture of the EU, in terms of its principal bodies, follows:

- The European Parliament,
- The Council of Ministers,
- The European Council,
- The European Commission, and
- The European Court of Justice.

**The European Parliament**  A directly elected body of 626 members, with representation from each member state based on the size of its population. Much of the work is undertaken by specialist committees, which make recommendations to full meetings held in Strasbourg.

**The Council of Ministers**  The ultimate decision-making body of the EU comprises one minister from each member state. The presidency of the Council rotates between members on a six-monthly basis. It is responsible for major policy decisions, which are published as regulations, directives, recommendations or opinions.

**The European Council**  Comprising the Foreign Minister from each member state, its role is to discuss and propose policy to the Council of Ministers.

**The European Commission**  The European Commission is the ‘civil service’ of the EU and guardian of the treaties. It has offices in Brussels and Luxembourg, and comprises Commissioners from member states and a staff of c. 20 000 drawn from all member states.

**The European Court of Justice**  Judges sit in Luxembourg to pass judgement on the interpretation of EU laws. The Court can set aside measures which have been adopted by the Commission, the Council or governments of member states which are incompatible with the treaties. Decisions are binding upon the member states.
Auditors need an understanding of the political environment in which their audit work is to take place so that they can contextualize the possible risks areas upon which they will later base their audit opinion.

We found Budd and Jones (1994) particularly insightful on the finer details of the EU, and further information is in the Reference section.

**The economic environment**

During November 1985, the US dollar and the GB pound sterling were trading roughly at parity (1:1) in London. At the time of writing, the exchange rate between these two great currencies is pretty close to 2:1. In a world where trade is often international, depending on where you operate, this would have had the effect of doubling or halving the price of raw materials and/or sales invoices. And of course, there are innumerable territories where this inflation/deflation ratio is much more significant. As markets globalize, the successes of organizations in different trading economies becomes increasingly interconnected. The economics of business are important external factors to be considered if an organization is to achieve its objectives.

**Scarcity**

Scarcity is based upon the relationship between consumers’ ‘wants’ and the resources available (referred to earlier as input–output–input) to satisfy these wants. Consumers’ ‘wants’ are said to be insatiable, whilst resources are inevitably finite. Thus choices have to be made concerning priorities.

For example, does a society want better healthcare, or better education?

In practice, scarcity is managed by a number of factors, including:

- price – e.g. diamonds are more expensive than rocks,
- rationing – e.g. tickets to ‘the Cup final’ are sold out, and
- queueing – e.g. there is a waiting list to see the eye surgeon.

Price is deliberately at the top of this list, and often sorts out the other two; supply and demand are set in the marketplace. Much can be learned by an organization by considering the scarcity and demand for its output.

**Case study**

A publisher of an annual sports almanac undertook a strategic review with the aim of increasing profitability. The review revealed that it was the only publication of its type, and that this scarcity provided a near-certain inelasticity in demand from its customers. It increased the sales price, and thus its profitability.
Economic systems

An important distinction in economic theory is between those that are centrally planned, and those that operate under market conditions.

Centrally planned economies
This type of economy is generally associated with socialist economies, such as China, Eastern Europe and Cuba. The main production decisions are taken by a central authority. Characteristics of this type of economy are:

• state control of resources,
• state control of priority for use of resources,
• targets for production to balance supply and demand are set by the State, and
• prices too are set by the State.

Free-market economy
More common in the early parts of the twenty-first century are free-market economies, where prices determine the allocation of resources. Characteristics of this type of economy are:

• privately owned resources, hence owners can choose how and when to consume them,
• privately owned organizations operate free from state intervention, and
• customer is king – consumers choose how to spend their money.

A-Factor 4: Recognize that, ultimately, market forces tell organizations – if they are listening carefully – what to produce (quality), when to produce it (delivery on time) and the price to charge (price). Set out, these objectives should be represented in the business plan.

Macro-economy

Macro-economic theory concerns an economy as a whole, dealing with such matters as overall levels of employment, the rate of inflation (use of a retail price index, RPI, measures how spending is affected by price changes), and the annual rate of growth of output (GDP) from an economy.

A simple economy comprises cyclical flows of money (and other financial instruments) between organizations and consumers, as

• organizations provide income to households (salaries) and
• households spend salaries on products by organizations and their services.

This cyclical flow shows that the fortunes of organizations are connected to the spending decisions of consumers; customers need to spend if organizations are to
prosper. Thus levels of income, output, expenditure and employment in any economy are interrelated.

Recession occurs when these macro-economic indicators move negatively, and growth occurs when they move positively. Government uses tools such as interest rates to encourage or suppress consumer activity to promote growth aligned to its own objectives for the economy. Similarly, increasing company taxation to raise public expenditure injects additional income into this circular flow of money.

External economic factors also influence the spending decisions of consumers, such as the 2005–2006 increases in the price of petrol at service stations, caused by increases in the world price for crude oil following, amongst other reasons, political instability in Iran and Russia, and supply chain interruptions caused by Hurricanes Katrina and Rita in the Mexican Gulf regions of USA.

Of course, the economy is much more complicated than this short section can possibly reflect. Everything affects everything else, and nothing can replace local analysis at the time any information is needed. Understanding how the macro-economy works helps organizations to set and achieve their business objectives.

**The role of financial institutions**

In a developed market economy, there will be a number of financial institutions, whose role it is to channel funds from those willing and able to lend to those wishing to borrow. These intermediaries include private banks, state banks and world banks.

Private banks generally lend to private customers on negotiated terms (usually based on the level of risk estimated in the transaction), gaining financial return from interest and other payments.

A state bank is a critical element in a country’s financial system (e.g. in Germany, Deutsche Bundesbank). Like most state banks, it exercises control over the domestic banking sector, and sets monetary policy to the needs of the economy.

World banks include:

- The International Monetary Fund (IMF),
- The Organisation for Economic Co-operation and Development (OECD), and
- The World Bank.

**IMF**

Established in 1946, its role is to provide a pool of international funds to promote growth in world trade. It also involves itself with assisting developing economies with debt problems.
OECD
A forum established in 1961 in which powerful countries meet to discuss world economies. Its decisions are not binding, but its research is used by G8, IMF and other bodies.

The World Bank
An agency of United Nations, established in 1945, to provide loans and technical assistance to developing countries.

The legal environment
Laws impact on many areas of activity conducted by all organizations. The areas that may be affected include, for example, minimum employment conditions (including health and safety), sales contracts for supply of goods and services, taxation, and environmental discharges to air, land and water. Penalty frameworks, known in the UK as sentencing guidelines, exist for those that are judged to have broken the law. These include fines and imprisonment for offenders.

This section provides an overview of the legal framework, written by non-legal practitioners for non-legal practitioners.

Classification and sources of law
Laws have evolved over many years; in the UK, these are said to date as far back as the conquest of the land by William (the Conqueror) in the year 1066. The essence of laws from a general perspective is that in return for the protection provided to an individual or an organization by a law, the same individual is constrained by the same law that protects them. Laws exist to regulate behaviours of individuals and organizations, and collectively set out the minimum standards of conduct desired at any time by society at large in the territory.

Laws are derived from historic custom and practice (known in the UK as ‘common law’), and written laws have passed through the political law-making process and the cumulative judicial decisions of the courts, where lower courts are obliged to follow the decisions, ‘the ratio decidendi’, of the higher courts.

As governments come and go, laws are enacted, repealed and amended. Thus the law in many countries is dynamic, and an auditor will need an appreciation of the legal framework that applies to the auditee’s organization.

Law can be defined in a number of ways; the main features within a typical legal framework are summarized here.
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Criminal law
Criminal laws relate to that which has been prohibited by legislation or statute in the interests of society at large, and are punished by the state upon conviction in a criminal court by a judge or a jury on behalf of the people. Fines and/or imprisonment are possible punishments. In the UK, the starting point for all criminal prosecutions is a Magistrate’s Court. More serious cases are referred to a Crown Court for judgement by a jury and sentencing by the judge.

Civil law and tort
The civil law concerns matters of law between individuals. A ‘tort’ is a civil wrong. Common torts include negligence, defamation and trespass. An award of damages or an Order of the court (perhaps requiring something to happen or something to stop) are typical outcomes. In the UK, civil judgements may be made in a County Court, and those where the remedy may be higher in value will be judged in the High Court.

Both the criminal and the civil law systems have superior courts, with a right of appeal in the UK to the Court of Appeal, and ultimately the House of Lords, which is the highest court for domestic purposes. Decisions of the European Court of Justice are supreme at European level.

Public law
Another useful distinction in law is between public and private law. Public law comprises those laws concerning the state, whether in national/international matters, or in the relationship between the state and an individual – for example tax laws.

Private law
Private law comprises those laws concerning the relationships between individuals, such as family, property, trust and contract laws.

International law
The world is becoming a smaller place. There is an increasing tendency for nations to accede to international laws and treaties.

The Montreal Protocol, for example, is the agreed international framework that bans, except in particular circumstances, the manufacture of chlorofluorocarbons (CFCs), as they are generally thought to damage the protective ozone layer around Earth.

As discussed earlier, the European Union has provided an impetus in Europe for a harmonization of legal standards in many areas. Regulations made by the Council of Ministers are binding in all member states. Directives must be implemented into the domestic legal frameworks of each member state.
Case study

An example of how European law can impact upon national matters was the interesting case of Jean-Marc Bosman, a Belgian footballer. Out of contract with Belgian club RFC Liege, Bosman sought to play the game in France with Dunkerque. When Liege demanded a transfer fee and the French club declined to pay, Bosman referred the matter to the European Court of Justice. In the 1996 judgement, it was ruled that clubs could no longer request a transfer fee if a player out of contract wished to play elsewhere in Europe, as it violated the right established in the Treaty of Rome for European workers to work in any member country. Since then, players regularly move from one club to another in these circumstances, and are commonly said to have ‘gone on a Bosman’ (Blanpain and Inston, 1996).

Business organizations and the law

As we have said, business is concerned with the conversion of input to outputs. The prevailing legal systems provide a controlling, constraining framework in which these activities should be conducted.

Business can be helped by laws (e.g. assistance to collect payment of invoices) as well as being constrained by them (e.g. prohibition of disposal of waste into drainage systems).

The following table provides some examples of interest to auditors of legal influences upon various business activities:

<table>
<thead>
<tr>
<th>Business Activity</th>
<th>Possible Legal Influences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Start up</td>
<td>Company, tax laws</td>
</tr>
<tr>
<td>Operations</td>
<td>Employment, health &amp; safety, product safety laws</td>
</tr>
<tr>
<td>Building extension</td>
<td>Planning, environmental, fire laws</td>
</tr>
<tr>
<td>Deliveries</td>
<td>Consumer, road safety, transport of dangerous goods laws</td>
</tr>
<tr>
<td>Being an auditor</td>
<td>As above, + defamation and contract laws</td>
</tr>
</tbody>
</table>

Tip – As an auditor (particularly if self-employed), it is a good idea to have a readily accessible source of legal advice. Some professional bodies offer such a service as a part of the membership fee. Alternatively, a relationship with a professional legal practice may be useful. Areas where such legal advice may be valuable include:

- review of terms and conditions of business,
- review of contracts (employment, work orders, etc.),
Business Environment

- review of wording of audit reports, and
- advice on legal matters.

The environment concerning resources

Businesses exist to produce goods, services, information and other outputs from their inputs. The critical inputs are human beings to ‘do the work’ and ‘buy the goods’, a supply of resources (renewable or non-renewable) and the necessary technologies for the process. In an earlier part of this chapter, we called these (as economists do) the factors of production – land, labour and capital.

Land and natural resources

Natural resources include land, land deposits, oceans and rivers, flora and fauna and the weather. An important distinction is between renewable resources and non-renewable resources. Either way, it is generally true that our resources are finite in supply (though small areas of land can be reclaimed from the sea at large cost).

Land use is renewable. We can build on it, demolish the structure, and build on it again. We can plant crops each year (though to do so on formerly industrial land would probably not be a good idea, unless an extensive ‘clean up’ has been done).

Fossil fuels are not renewable. When we extract oil, refine and introduce it to an internal combustion engine, that oil is gone forever. How many years of hydrocarbon fuels remain is subject to debate, and probably uncertain at this time.

In recent years, ‘the environment’ has become centre-stage, both politically and as a necessity. Predicted rates of increase in average temperatures have compelled attention, particularly to reduce CO₂ emissions. At the same time, recycling and energy efficiency have become prominent in many developed areas of the world. Whether we have done enough waits to be seen.

Labour (people)

Human beings are important, both as producers and consumers of goods and services. Figure 1.2 and the associated text will serve as a reminder. Many production processes are people-intensive, and accordingly, having a suitable supply of educated, motivated and affordable staff is important to most businesses. Throughout their working careers, many organizations will tend to want to develop the education and motivation of their staff, and reward successes in these areas with promotions and salary increments.

Organizations seeking to develop their business in a territory will find the following factors helpful in identifying a workforce:

- the total population of a territory,
- the age structure of the population,
Business Environment

- the retirement age,
- the working population,
- the mobility of the working population,
- the occupational structure of the working population,
- the education level of the working population,
- the length of the working week, and
- wage levels/minimum wage levels/trade union involvement.

Marketers conduct similar analyses for establishing customers and markets.

Tip – In the UK, annual statistics on some of these and many other demographic factors are published by the Office of National Statistics and available from The Stationery Office. Refer to this (or similar documents) when detailed information is required.

Case study

A small organization’s business was buying and selling of concert souvenirs for ‘B’ list artistes and bands on tour. When it identified large foam ‘spongy hands’ printed with the artiste’s name as a potentially attractive product, it purchased 1000 at a cost of 20p (a fifth of £1 GBP), and sold out at £3 (GBP) each on the first night of a multi-night concert tour by a comeback act – a mark-up of 1500%. In the second year as his memorabilia agent, the organization trebled its order, and sold out on the second night of the tour. Expecting to ‘make it big’ in the third year, the purchase order was multiplied by ten, still at the year-one cost price. The organization was not able to sell even one of its orders. Why?

The year was 1997, and artiste’s name was Paul Gadd, known to his fans as Gary Glitter. Many external factors are way beyond the control of organizations.

Capital and technical factors

Flows of capital to business are undiminished, and these are providing for unprecedented changes in the input → process → output cycle. There have been simply massive changes in technology in recent years, and (for some, perhaps worryingly) as Fareed Zakaria, Editor, Newsweek International observed in Newsweek magazine (2006):

The 21st century will be the century of change. More things will change in more places in the next ten years than in the previous 100.
Technological change leads to new products and services (including profound changes to the life expectancy of human beings as previously incurable conditions are treated), new markets, increased automation and displacement of people from processes, faster exchange and storage of data and information, and greater possibilities for intrusion and loss of privacy.

The internet is presently transforming the way in which people shop, communicate and access information. It is difficult to predict how the internet will change in the future, suffice to say it will.

Research into (for example) new processes, materials, crops, pharmaceuticals, vehicles, and sources of energy turns up new developments all the time.

Barriers to technical developments include lack of skill in the workforce, or redundant skill, where technology has moved at a pace where parts of a workforce have not been retrained quickly enough. Exhaustion of natural resources (as noted earlier), and particularly fossil fuels, could impede future technical developments.

All of these three inputs to businesses – land, labour and capital – are interconnected. For example, the productivity of human beings and the efficiency of plant and equipment will be impacted by the technology available to them at any point in time. These inputs are essential to organizations, because without them, conversion can not take place.

As an auditor, it is likely that you will be exposed to new technology, ranging from the R&D department in the auditee’s organization, the new lean-burn aircraft you flew to site in, through to the new audit-reporting software on your palmtop computer. As part of your CPD (continuing professional development) programme, keeping abreast of appropriate developments is a good idea.

**Management’s interpretation of their own business environment**

Management’s role is to take account of the business environment considered by them to be reasonably relevant to their sphere of operation, and to reflect this output of their analysis in the decisions that they make, based on their most realistic interpretation of the opportunities and/or threats faced. The most usual place for this will be contained within their business plan, and the specific objectives contained within it.

Management will often express their analysis and the subsequent developments expected of their businesses in a series of corporate documents. The first of these is often a statement of ‘vision’ of how the organization will be in the future. A ‘mission’ statement provides the purpose of the organization, and a series of business objectives for the plan year and beyond will be established. These will be used as a means to
cascading the essential activities (as seen by the top management) throughout their organization.

Figure 1.5 shows how this ‘cascade’ looks.

A-Factor 5: Top management should balance the influences of the competing external and internal environments to face its target market(s) with aligned and well-communicated business objectives.

As auditors, you’ll learn in this book that your work concerns the likelihood and the severity of impacts on the achievement of these business objectives. You should be prepared also to challenge these set objectives in appropriate circumstances.

**What is risk?**

Ask a manager from the twenty-first century ‘what is risk?’, and as likely as not, you’ll be told that it is an estimation of the likelihood and severity of some physical harm occurring. Health and safety managers have been busy in many organizations, and risk assessments are common in developed territories. In this understanding, some managers will use words such as frequency or probability, and some will use words such as impact or consequence. Either way, most will know that risk concerns a reasoned view of the future that can be calculated and planned. The greater the risk, the greater the need for control.
No director can ignore the risk to the reputation of his (sic) company and its brand that health and safety and environmental expectations present.

– Sir Nigel Rudd, one of The Times Power 100, and holder of four FTSE directorships (in Eves and Gummer, 2005).

However, ‘risk’ can, and should, be defined as any type or source of harm – either perceived as positive or believed to be negative (also referred to in this book as ‘value creation’ and ‘value protection’) – with potential for impact upon the achievement of the organization’s stated (or formally unstated, but still obvious) objectives:

... the combination of the severity of harm with the likelihood of its occurrence ...

– From HSG65, Health and Safety Executive (1997).

combination of the likelihood and consequence(s) of a specified hazardous event occurring


... a combination of the hazard and the loss and, in any given set of circumstances, risk takes into account the relevant aspects of both.

– Boyle (2002).

... the chance of a particular situation or event, which will have an impact upon an individual’s, organisation’s or society’s objectives, occurring within a stated period of time.


Risk can be expressed and measured in two main ways:

- gross and
- residual.

**Gross risk**

Gross risk implies the risk exposure before the effect of the selected business control framework is accounted for. Some call this the ‘pure’ or ‘inherent’ risk.

**Residual risk**

The residual risk is the remaining risk exposure after the mitigating and compensating factors of the business control framework are accounted for. Some controls tend
to reduce likelihood (e.g. preventative controls such as a well-trained workforce or fixed guards on machines) and some controls tend to reduce severity (i.e. detection, containment, mitigation and restoration controls). Other controls can reduce both likelihood and severity (elimination and substitution controls, such as low-toxicity chemicals). Some call this residual risk the ‘net risk’.

A true case study?

Asbury and Ashwell were exploring at the North Pole, when they came about a huge polar bear. The bear growled angrily, and it rubbed its stomach in a hungry manner, clearly relishing the hearty meal which had just walked in. As experienced visitors to polar climes, the intrepid explorers were both wearing the expected ‘tennis racket style’ snow-shoes as part of their risk control measures. Asbury began removing his snow-shoes so as to be able to make a dash to safety. Ashwell said, ‘But Steve, you’ll never outrun a polar bear in its own terrain.’

As a risk manager, what would have been Asbury’s response?

His response – ‘I don’t have to; I have to outrun only you!’

A-Factor 6: Risk is anything which may hinder or assist achievement of business objectives. It is generally quantified in terms of its residual likelihood and severity. Value creation and value protection are the essence of an organization’s success.

A brief history of risk

‘Risk’ has a fascinating history, which is beautifully narrated by Peter Bernstein in his book *Against the Gods* (1996). You would not have to go back in time many years for modern clarity of approach and measurement to be lost. A well-educated individual a thousand years ago would not recognize the number ‘0’, and would probably not pass a basic mathematics test. Five hundred years later, few would do very much better. Without some form of measurement, some numbers, risk was a matter of gut feel.

The ‘power of numbers’ arrived in the West in the early thirteenth century, when a book entitled *Liber Abaci* appeared in Italy, a wholly handwritten fifteen volumes written by Leonardo Pisano (but commonly known as Fibonacci). Fibonacci is best known for a series of numbers, which provided the answer to the problem of how many rabbits will be born during the course of one year from one pair, while assuming that every month, each pair produces another pair, and that rabbits start breeding aged two months – the answer is 233; and the twelve month-end totals for the year would be 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, 233. Each successive number is the sum of the two preceding numbers, and if one number is divided by the next, the answer is approximately 1.6. This ratio features in nature (e.g. in shell spirals, leaves and flowers) and in architecture (e.g. the General Assembly Building of the United Nations in New York). Playing cards are similarly proportioned. The Fibonacci series
also features in the book and film *The Da Vinci Code*, where a dying Jacques Sauniere leaves a code for Robert Langdon to decipher. Fibonacci identified the ‘power of numbers’ in the West for the first time, but using them to assess risk still remained many years in the future.

Bernstein (1996) comments on the development of risk over the last millennia:

> What is it that distinguishes the thousand years of history from what we think of as modern times? The answer goes way beyond the progress of science, technology, capitalism and democracy. The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk: the notion that the future is more than a whim of the gods and that men and women are not passive before nature. Until human beings discovered a way across that boundary, the future was a mirror of the past or the murky domain of oracles and soothsayers.

He gives an interesting account of this history, suggesting that:

> The ability to define what may happen in the future and to choose amongst alternatives lies as the heart of contemporary societies.

### Hazard and risk

A modern definition of hazard is ‘the potential for harm’. The word hazard is said to derive from the Arabic word for dice – *al zahr*.

We have seen a representative sample of definitions of risk on page 000, though there are many others. The word risk is said to derive from the early Italian *risicare*, which means ‘to dare’. To dare implies the freedom to choose, and possibly to fail.

Dice is a game of luck, of pure chance, of pure hazard. Whilst lots of things have potential for harm (*al zahr*), managers can choose to dare, and decide how and when to respond to hazards. This choice influences the likelihood of the harm occurring and the severity of this harm, should it occur.

This ‘daring’ to participate in the business environment includes choosing to stop doing something (or not starting in the first place) if the risk is too great. Other choices are to transfer the risk to someone else (to share or insure), or to take actions to mitigate the risk (treatment). After the choices have been taken, the residual risk is taken knowingly.

### Case study

The scientist who developed the Saturn V rocket responsible for mankind’s forays to the Moon put risk this way:
You want a valve that doesn’t leak and you try everything possible to develop one. But the real world provides you with a leaky valve. You have to determine how much leaking you can tolerate.

Once in a coffee shop . . .

As noted, there are several ways of dealing with ‘risk’. One of these is to insure against loss. Insurance works when the losses of the few are reimbursed by the premiums of the many. Following the great fire of London in 1666, there was an increasing demand for insurance. Business people would meet in coffee shops, and one of those rose to prominence.

Edward Lloyd opened a coffee shop on Tower Street, London which was firmly established by 1688. It was a popular place for London’s sailors; so popular that it moved to larger premises in Lombard Street in 1691. Responding to the needs for shipping information from his customers, he provided a schedule of arrivals and departures of ships from the port of London. Thus ‘Lloyd’s list’ was born, and later used by captains of ships to consider the risks in various shipping routes.

Shipowners seeking insurance would go to a broker who, in turn, would ‘sell’ (or transfer) portions of the total risk to individuals, who would confirm their agreement to cover a percentage of any loss by signing his name to the contract. Such ‘writing under’ each other, to cover the full value became known as ‘underwriting’.

By 1771, seventy-nine of these underwriters had each subscribed £100 each to form the Society of Lloyd’s – the original ‘Lloyd’s names’. The names committed all their assets to secure their insurance promise. That commitment was the principal reason for the rapid growth and excellent reputation held to this day of insurance underwritten at Lloyd’s. After several relocations, it moved to One Lime Street, its current location, opened by the Queen in November 1986.

Case study

When anyone asks me how I can best describe my experience of nearly forty years at sea, I merely say uneventful. Of course there have been winter gales and storms and fog and the like, but in all my experience, I have never been in an accident of any sort worth speaking about. I have seen but one vessel in distress in all my years at sea . . . I never saw a wreck and have never been wrecked, nor was I ever in any predicament that threatened to end in disaster of any sort.
The practicalities of understanding risk

We have discussed earlier the basic system for transformation of inputs to outputs to inputs (see Figure 1.2 and associated text).

Figure 1.6 shows the reality of this for any business. On the left side is the aspiration of the entrepreneur, seeking funding for the enterprise, and investment in the necessary resources. On the right side is the ‘Vision’, of the achievement and success stated in whatever terms those entrepreneurs have decided. Connecting the two sides is ‘risk management’, which certainly is not a game of cards.

Not all organizations are equally successful, and how any business responds to the risks in its environment will be a significant feature of its success (or failure).

Figure 1.7 shows a simple risk-ranking matrix, and Figure 1.8 shows how a corporation has developed this to highlight a variety of risk areas in greater detail.

A-Factor 7: \[ r = L \times S \] (Risk = Likelihood \times Severity).

The greater the risk, the greater the (implied) urgency for response to that risk. Just how low a residual risk should be depends upon the ‘appetite’ for risk in the

![Figure 1.6: Risk – ‘Not a Game of Cards’](image-url)
management of the organization. Some readers will be familiar with terms such as ‘ALARP’ (As Low As Reasonably Practicable) and ‘so far as reasonably practicable’, but these are beyond the scope of this book. Suffice to say that there is an established hierarchy for risk response (treatment), known as ‘ERIC’, as follows:

- **Eliminate** – terminate exposure to the hazard;
- **Reduce** – reduce the exposure;
- **Isolate** – contain the hazard by physical or other means; and
Business Environment

- Control – other means, including safe systems of work, training and so on.

Tip – Remember ‘famous Eric’, when a significant risk is identified. Many people have a ‘famous Eric’ – whether a parent, a relative or a friend. In training courses, to encourage delegates to remember ‘ERIC’, we have referred to Eric Cantona (famous footballer), Eric Morcambe (famous comedian) or Eric Clapton (famous musician).

A-Factor 8: Look for the application of ERIC whenever and wherever there is a significant risk

Auditors and risk

An essential first step for an auditor is to consider risks in the context of the environment in which the auditee’s organization is operating – of course, not all environments are the same (politically, economically, legally or otherwise).

We have described the process for estimating risks (e.g. using a typical risk assessment matrix to qualitatively assess the significance of each identified risk area), and in effect, auditors will be following in the footsteps of the auditee’s management when they are selecting a sample of risks for review and verification in their audit work plan.

Three questions (Asbury, 2005) will invariably assist auditors (as no doubt it may have assisted management) to decide the significance of the identified risks:

- how often will this happen (the likelihood, frequency, probability)?
- how big could the impact be (the severity, impact, consequence)?
- who is likely to be impacted by an occurrence (which stakeholder groups)?

NB – By ‘stakeholders’, we mean five specific groups – shareholders, customers, employees, suppliers and society at large.

The authors recommend that HSEQ auditors focus upon the relative incidence of risks within the auditee’s activities. A useful idea is to focus on the top 10–20 of such risk areas, ultimately selecting a sample size depending on the time available.

There are many quantitative risk evaluation/estimation methodologies and software toolkits available. Too much focus on precise risk-scoring by auditors can easily become counter-productive, and this is supported by our experience of over 1000 audits and the feedback from thousands of our course delegates. Therefore, it is wise to avoid the ‘numbers game’ (Asbury, 2005). Qualitative methodologies are generally better suited for use by HSEQ auditors, who will have less time available than full-time site managers to select and investigate a sample of risks.
A-Factor 9: Know that ultimately an audit is an independent and balanced assurance to stakeholders regarding an organization’s ability to meet its business objectives, in increasingly volatile business environments.

In Chapter 2, we will consider the development and rise of business control as a technique for making a successful transition from vision to reality more likely.

For example, organizations seeking excellence in worker health and safety are increasingly likely to use systematic techniques to meet (UK) legal requirements first established in 1802, and significantly amended in 1961, 1974 and 1992. From the first environmental law in 1307, when Queen Elizabeth published a proclamation prohibiting the burning of sea coal in London while Parliament was in session (Willis Corroon, 1996), up to the newest legal requirements for Integrated Pollution Prevention and Control (IPPC), business control frameworks have provided a systematic approach for the twenty-first century.

We will also summarize the relatively new and important theme of corporate social responsibility (CSR), comprising the increasing expectation by all organizational stakeholders for transparency. The business response to CSR has provided both ‘greenwash’ (such as pictures of meadows, trees and children); plus targets and statistics galore.