CHAPTER A: BUSINESS ENVIRONMENT AND ECONOMICS

1.0 Business Fundamentals, Accounting and Ethics

1.1.1 What is the Concept of Business?

The Concept of Business A business is defined as an organized effort to provide goods or services to meet a market need.

- **Context:** Modern businesses in Sri Lanka operate in a complex environment driven by digital economies, sustainability requirements (ESG), and regulatory changes.

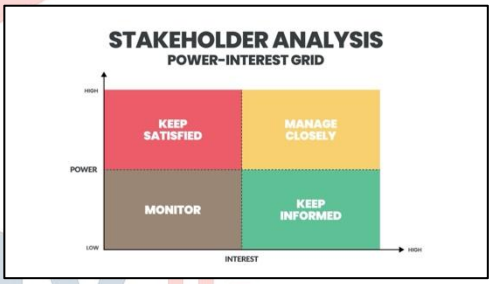
- **SME Relevance**: Small and Medium Enterprises (SMEs) are the backbone of the Sri Lankan economy but face resource constraints and must adapt to new standards like SLFRS S1/S2.

Core Purposes of a Business Beyond simple trading, a business exists to achieve four main goals:

- **Profit Generation:** Essential for survival, innovation, and investor returns.
- **Value Creation:** Developing quality goods/services to build customer loyalty.
- **Employment**: Providing jobs to support economic stability.
- **Societal Contribution**: Paying taxes and adopting sustainable practices as a responsible corporate citizen.

1.1.2 Stakeholder Analysis

A stakeholder is any individual or group affected by a business's actions. Managing these relationships involves balancing often conflicting interests (e.g., shareholders want profit vs. employees want higher wages).



Key Stakeholders in the Sri Lankan Context

Stakeholder	Role	Key Interests	Relationship/Impact
Shareholders	Provide capital & risk	Returns (Dividends), Profitability	Balance returns with ESG costs
Employees	Labour & Skills	Wages, Job Security, Safety	Critical for productivity and retention
Customers	Revenue Source	Quality, Fair Pricing, Ethics	Trust-based; determines market share
Suppliers	Resource Providers	Prompt Payment, Contracts	Essential for supply chain resilience

Stakeholder	Role	Key Interests	Relationship/Impact
Creditors	Debt Financing	Repayment, Stability	Sensitive to interest rates/Central Bank policy
Govt/Regulators	Legal Framework	Taxes, Compliance	Compliance with bodies like CA Sri Lanka & SEC
Community	Social License	Environment, CSR	Sustainability and environmental footprint

1.1.3 Business Structure Types and Comparative Analysis

Choosing a structure is a strategic decision affecting liability, tax, and capital access.

i. **Sole Proprietorship**

- **Definition:** Owned by a single individual. The owner and business are the same legal entity.
- **Liability:** Unlimited personal liability (personal assets are at risk).
- **Registration:** Must register under *Business Names Ordinance No. 6 of 1918* if not using the owner's full name.
- **Tax:** Taxed as personal income; no separate corporate tax.

ii. **Partnership**

- **Definition:** Two or more people sharing ownership, management, profits, and risks.
- **Governing Law:** *Partnership Act of 1890*.
- **Features:** 2–50 partners; Unlimited liability (joint and several); No separate legal existence.
- **Tax:** The partnership does not pay income tax; net income is allocated to partners and taxed individually.

iii. **Company (Limited Liability)**

- **Definition:** A separate legal entity distinct from its owners (shareholders).
- **Liability:** Limited liability (shareholders generally only risk their investment).
- **Registration:** Regulated by the *Companies Act*. Types include Pvt Ltd, PLC, Guarantee, etc..
- **Governance:** PLCs must comply with the *Code of Best Practice on Corporate Governance* (issued by CA Sri Lanka/SEC)

Summary Comparison

Feature	Sole Proprietorship	Partnership	Company
Legal Status	No separate entity	No separate entity	Separate Legal Entity
Liability	Unlimited	Unlimited	Limited
Capital Access	Limited (Personal)	Moderate (Pooled)	High (Shares)
Complexity	Minimal	Moderate	Extensive
Decision Making	Owner	Partners	Board of Directors

1.1.4 Business Functions and Organisational Operations

Business functions are specialized departments working together to achieve goals. In Sri Lanka, these functions must now adapt to digital changes and SLFRS S1/S2 standards.

Core Functions:

- **Accounting**: The financial backbone. Records transactions, prepares statements, ensures compliance.
- **Finance**: Manages money, investments, and risk.
- **Marketing**: Drives sales, brand building, and customer analysis.
- **Human Resources (HR):** Manages recruitment, training, culture, and compensation.

Operational & Support Functions:

- **Operations/Production**: Focuses on efficiency, quality control, and manufacturing.
- **R&D:** Drives innovation and new product development.
- **Supply Chain/Logistics**: Manages procurement, inventory, and physical distribution.
- **Administration**: Governance and policy coordination.

1.1.5 Business Function Interactions and Accounting's Role

While functions are distinct, they must integrate. Accounting acts as the "central nervous system" of the business.

- The Role of Accounting: It translates the activities of HR, Marketing, and Ops into a common language: Money.

- Decision Support:
  - For Marketing: Accounting provides data on product profitability to help set prices.
  - For Operations: Cost-benefit analysis helps decide on equipment upgrades.
  - For Strategy: Budgeting aligns all functions with company goals.

Note: *Remember that Accounting is not just recording history; it provides the objective financial information required for future strategic decisions.*

1.1.6 Stakeholder Value Creation and Ethical Responsibilities

Modern business success is defined by broader value creation, not just profit.

Value Creation Components

- **Economic**: Prosperity for shareholders and community.
- **Social**: Improving quality of life and well-being.
- **Environmental**: Stewardship of natural resources.

Ethical Responsibilities Ethics are no longer optional; they are central to strategy.

- **Transparency:** Openness in communication.
- **Accountability:** Taking responsibility for actions.
- F**airness:** Treating stakeholders equitably.

Link to ESG: These principles are formalized through Environmental, Social, and Governance (ESG) criteria and reported via digital systems.

1.2 Modern Business Developments

Businesses are being reshaped by three interconnected forces: Technology, Data Analytics, and Sustainability.

1.2.1 Emerging Technology Trends and Business Transformation

Technology is the core engine of strategy. It creates efficiency but brings risks like cybersecurity threats.

Key Technologies:

- **AI & Machine Learning (ML):**
  - *Function:* Analyze vast data to find patterns/predict trends.
  - *Sri Lanka Context:* Used for compliance tools and advanced analytics, though a "skill gap" exists.
- **Cloud Computing:**
  - *Function:* Scalable computing over the internet.
  - *Benefit:* Cost-effective for SMEs; enables flexible platforms for tax/ESG reporting.
- **Internet of Things (IoT):**
  - *Function:* Network of physical devices collecting real-time data.
  - *Benefit:* Supply chain visibility and "Big Data" generation.
- **Blockchain:**
  - *Function:* Secure, decentralized digital ledger.
  - *Benefit:* Increases trust; tracks product authenticity from farm to store (supply chain transparency).
- **Automation & Robotics:**
  - *Function:* Tech performing human tasks (Physical robots or RPA software).
  - *Benefit:* Efficiency and quality.

1.2.2 Data Analytics Impact on Business Decision-Making

Data is a strategic asset. Analytics turns "Big Data" into actionable insights.

Types of Analytics:

- **Financial Analytics:** Risk assessment and performance measurement.

- **Operational Analytics:** Process improvement.
- **Customer Analytics:** Understanding behaviour for marketing.
- **Supply Chain Analytics:** Optimizing logistics.

Business Intelligence (BI): BI tools and data visualiz
for presenting these insights to decision-makers in a si
businesses from "gut feeling" to evidence-based decisi

<u>1.2.3 Sustainability and Governance Significance (ESG)</u>

Sustainability is the "compass" guiding modern business.

- The Shift: From focusing only on profit to a broader view of success involving Environmental, Social, and Governance (ESG) factors.

- Regulatory Drivers in Sri Lanka:
  - SLFRS S1 & S2: New mandatory reporting standards for sustainability disclosures.
  - Social License: Companies engaging in ESG build credibility. Ignoring it risks losing the "social license to operate" (trust from the community).

Key Takeaway: Sustainability is no longer a "nice-to-have." It is a core compliance requirement and a driver of long-term value creation.

2.0 Economics and Business

This section bridges economic theory with business strategy. It moves from the micro-level decisions of individual firms to the macro-level forces of the national economy.

2.1 Microeconomics in Business

<u>2.1.1 Microeconomics Definition and Business Significance</u>

Microeconomics is the study of decision-making by individual units such as consumers, workers, and firms facing the problem of **scarcity**. It focuses on how these individuals allocate limited resources to satisfy unlimited wants.

Business Significance For a business leader, microeconomics is not abstract theory; it is a toolkit for strategy.

- **Resource Allocation:** Helps businesses prioritise investments (e.g., choosing between a marketing campaign vs. equipment upgrades)

- **Pricing Strategy:** Essential for setting prices that maximise revenue based on consumer demand.
- **Market Analysis:** Provides a framework to analyse competitors and market structures (Perfect Competition, Monopoly, etc.).
- **Sri Lankan Context:** For SMEs in Sri Lanka, limited access to capital makes efficient resource allocation critical. Understanding these principles helps in making "make-or-buy" decisions and optimising supply chains.

2.1.2 Key Microeconomic Concepts Recognition

i. **The Core Economic Problem**

- **Scarcity:** Resources (Land, Labour, Capital, Entrepreneurship) are limited, but human wants are unlimited.
- **Choice:** Because of scarcity, businesses must make choices.
- **Opportunity Cost:** The value of the next best alternative foregone when a decision is made.

- *Example:* If a firm spends Rs. 1 million on advertising, the opportunity cost is the factory upgrade it *didn't* buy with that money.

ii. **Utility**

The ability of a good or service to satisfy a human need or want. Understanding utility helps businesses design products that customers value.

iii. **Factors of Production (Economic Resources)** These are the inputs required to create goods/services:

- **Land:** Natural resources.
- **Labour:** Human effort and skills.
- **Capital:** Machinery, buildings, and tools.
- **Entrepreneurship:** The drive to organize the other factors and take risks.

2.1.3 Demand and Supply Principles and Market Outcome

These are the two fundamental forces that drive market economies.

i. **Demand (The Consumer Side)**

- **Definition:** The desire for a product backed by the *ability* and *willingness* to pay.

- **Law of Demand:** There is an **inverse relationship** between price and quantity demanded. (Price increases, Demand decreases and vice versa), assuming other factors remain constant

- **Shifters of Demand:** Changes in consumer income, tastes, prices of substitutes/complements, and expectations.

ii. Supply (The Producer Side)

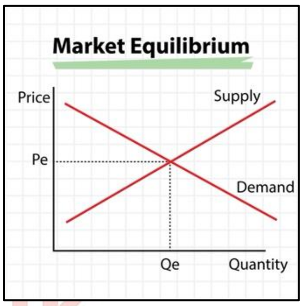
- **Definition:** The amount of goods firms are willing to sell at a given price.

- **Law of Supply:** There is a direct relationship between price and quantity supplied (Price increases, Supply increases and vice versa), assuming other factors remain constant.

- **Shifters of Supply:** Changes in production costs, technology, government regulations, and the number of suppliers.

2.1.4 Market Equilibrium and Disequilibrium Implications

- **Market Equilibrium**: The point where Quantity Demanded = Quantity Supplied.
- **Equilibrium Price:** The "market-clearing" price where there is no surplus or shortage
- **Stability:** The market naturally settles here.
- **Disequilibrium** states that when the price is *not* at equilibrium, the market is unbalanced.



State	Definition	Cause	Strategic Response
Surplus (Excess Supply)	Supply > Demand	Price is too high (above equilibrium).	Lower prices (discounts), reduce production, manage inventory
Shortage (Excess Demand)	Demand > Supply	Price is too low (below equilibrium).	Increase prices, ramp up production, manage customer expectations

***Strategic Insight**: In digital markets, algorithmic pricing can cause rapid shifts between equilibrium and disequilibrium. Real-time data monitoring is essential.*

2.1.5 Elasticity Concepts and Business Applications

Elasticity measures **sensitivity**: how much one variable changes in response to another.

i. Price Elasticity of Demand (PED) - Measures how quantity demanded responds to price changes.

- **Elastic (PED > 1):** Consumers are sensitive. A price drop increases total revenue.
- **Inelastic (PED < 1):** Consumers are insensitive. A price increase raises total revenue.
- **Unitary (PED = 1):** Price change leads to proportional demand change. Revenue stays constant.

Other Elasticities

i. **Price Elasticity of Supply (PES):** Responsiveness of supply to price changes.

ii. **Cross-Price Elasticity (CPED):**

Substitutes (+): When Price of Coffee increases, demand for tea will increase

Complements (-): When Price of Petrol increases, demand for Cars will decrease.

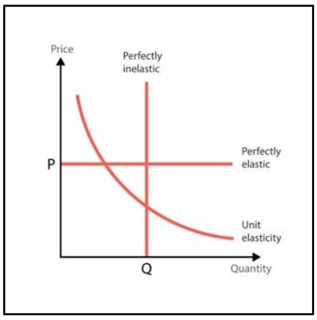
iii. **Income Elasticity (YED):**

Normal Goods (+): When Income increases, demand increases

Inferior Goods (-): When Income increases, Demand decreases (e.g.: low-quality staples)

Strategic Application

Elasticity Type	Business Application
PED	Setting prices to maximise revenue; deciding on discounts.
CPED	Analysing competitors; bundling products (complements).
YED	Forecasting sales during economic booms or recessions.



2.2 Macroeconomics in Business

Macroeconomics looks at the "Big Picture"—the national and global environment in which businesses operate.

2.2.1 Macroeconomic Policies and Business Implications

Government policies act as external forces that shape business costs, demand, and competition.

Overview of Key Policies:

i. **Monetary Policy:** Controlled by the Central Bank (CBSL). Affects interest rates and money supply.
ii. **Fiscal Policy:** Controlled by the Government. Involves taxes and spending.
iii. **Exchange Rate Policy:** Manages currency value. Affects export/import competitiveness.
iv. **Trade Policy:** Tariffs and duties (e.g., 10-15% customs duties in Sri Lanka)
v. **Regulatory Policy:** Compliance rules (e.g., SLFRS S1/S2 for sustainability).

Strategic Responses: *Businesses can be Proactive (forecasting changes), Reactive (adjusting quickly), or Integrated (embedding policy trends into core strategy).*

2.2.2 Monetary Policy Tools and Business Implications

Monetary policy is the primary tool for managing inflation and economic stability. In Sri Lanka, this is managed by the Central Bank of Sri Lanka (CBSL).

Key Tools & Impacts:

i. **Policy Interest Rates:**
   - **Mechanism**: Benchmark rates for lending to commercial banks.
   - **Impact**: Directly affects the cost of borrowing. Higher rates increase finance costs for businesses and reduce consumer spending.

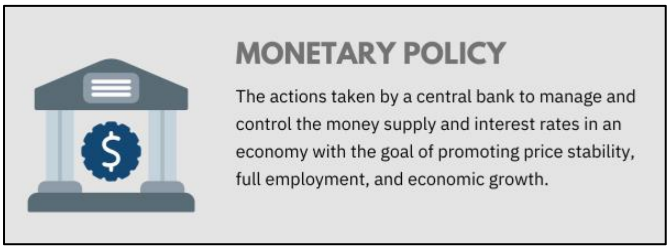
ii. **Open Market Operations (OMO):**
   - **Mechanism**: Buying/selling government securities.
   - **Impact**: Injects or absorbs liquidity (cash) from the banking system, affecting credit availability.

iii. **Reserve Requirements (SRR):**
   - **Mechanism:** The % of deposits banks must keep with CBSL.

- **Impact:** High SRR reduces the money banks can lend, tightening credit for businesses.

Business Strategy for High Interest Rates:

- Delay large capital projects.
- Focus on cash flow efficiency.
- Reduce debt levels.



2.2.3 Fiscal Policy Tools and Business Implications

Fiscal policy involves the government's use of its budget to influence the economy.

Key Tools:

i. **Taxation:**

- **Direct**: Corporate tax (impacts net profit).
- **Indirect**: VAT (impacts consumer prices and demand).
- **Sri Lankan Context**: Recent tax reforms aimed at increasing revenue-to-GDP ratio affect cash flows and pricing strategies.

ii. **Government Spending:**

- **Infrastructure:** Improves logistics and reduces long-term costs for businesses.
- **Subsidies:** Lower costs for specific sectors (e.g., agriculture, green energy).

iii. **Budget Deficit/Surplus:**

- A deficit often leads to government borrowing, which can push up interest rates ("crowding out" private investment).

2.2.4 Exchange Rate Policy and Business Consequences

Exchange rates determine the value of the Sri Lankan Rupee (LKR) against foreign currencies.

Regimes:

i. **Floating:** Determined by market supply/demand. High volatility.
ii. **Fixed:** Pegged to another currency. Stable but rigid.
iii. **Managed Float:** Market-driven with CBSL intervention.

Business Impacts:

i. **Importers:** Depreciation increases the costs of raw materials.

ii. **Exporters:** Depreciation makes goods cheaper for foreign buyers (competitive advantage), boosting revenue in LKR terms.

Managing Currency Risk:

i. **Transaction Risk:** Use hedging tools like forward contracts.
ii. **Translation Risk:** Accounting exposure for foreign subsidiaries.
iii. **Economic Risk:** Long-term strategic exposure. Diversify markets.

2.2.5 Contemporary Macroeconomic Indicators

These indicators act as a "dashboard" for business decision-making.

Indicator	Measures	Business Significance
GDP	Total economic output	Signals market growth potential. 78% of firms plan investment based on growth signals.
Inflation (CPI/PPI)	Rate of price increase	Affects pricing strategy, wage negotiations, and input costs.
Unemployment	Labour market health	Low unemployment = tight labour market, higher wage costs, difficulty hiring.
Interest Rates	Cost of capital	Determines the "hurdle rate" for new investments.
Confidence Indices	Business/Consumer optimism	Predicts future demand. High confidence suggests it's time to expand.