Basics of Financial Management

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Third Edition

Noordhoff Uitgevers

Includes online tests! (login details inside)

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Preface third edition

Basics of Financial Management offers a complete introduction to the subject. It can be used by undergraduates in higher economic education programs, but is also suitable as a basic course for non-economic academic programs.

Part 1 of this book offers a fully-fledged introduction to financial management, in which the student becomes acquainted with the functioning of companies and the most important underlying economic aspects.
Parts 2, 3 and 4 discuss the disciplines of finance, management accounting and financial accounting. These parts can be studied in random order.

In this third edition, there is a seamless connection between *Basics of Financial Management* and the Dutch version *Basisboek Bedrijfseconomie*. The result being that both books have an international perspective. The institutional aspects (such as tax and corporate law) that are important for the Dutch context, are also discussed in the English edition.

In the third edition, we have used American English instead of British English. As a consequence, the third edition deviates from the previous edition on a number of points, in particular where it concerns financial terminology.

Some topics have been added, which were not (or only briefly) discussed in the previous edition. These concern the influence of the cash flow cycle on working capital, uncertainty with regard to capital budgeting, the balanced scorecard and customer profitability analysis. Of course, where necessary, the contents have been updated.

Test questions and multiple-choice questions are incorporated in the *Basics of Financial Management*. The answers to these questions are provided at the back of the book.

The accompanying *Exercise book* contains a large number of questions and cases of increasing difficulty. A part thereof is fully explained in the *Answers and Solutions.* The remaining answers can be found in the teacher's section of the website: www.basicsfinancialmanagement.noordhoff.nl. The student's section of the website contains interactive questions and a definition trainer.

Since the first Dutch edition over a quarter of a century ago, the book has been widely taken on board. We hope this third English edition will be the basis of a successful continuation.

All remarks or comments by users, both students and teachers, are very welcome.

The authors

Contents

Introduction

Basics of Financial Management offers (future) professionals with a non-specific financial position, an understanding of finance related issues, at such a level that they can act as a fully-fledged interlocutor of financial specialists. Furthermore, the book is also intended as a basic training to prepare students in financial-economic education programs for a more in-depth study of the subjects.

To enhance the user-friendliness of the book, a brief explanation on the possible use is provided hereafter.

The book comprises four parts: 1 *Businesses and their role in the economy*, 2 *Finance*, 3 *Management accounting* and 4 *Financial accounting*.

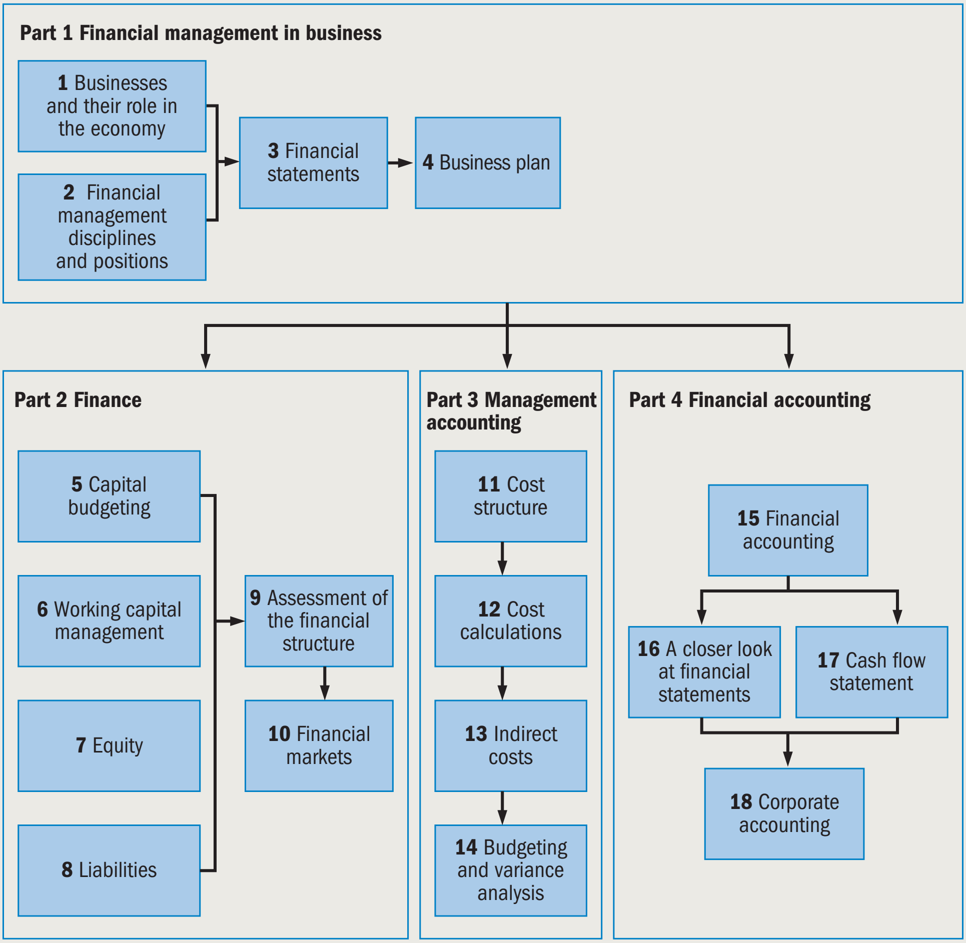
The first part provides an understanding of some basic terminology in business economics. It is recommended to start with this part. Armed with this knowledge, the following three parts can be studied independently from one another.

To support students who are interested in studying one specific topic (for example because they are enrolled in a problem-based or project-based education program) a schedule that shows the mutual relationships between the chapters in the book is incorporated in this introduction. This allows the student to verify whether prior knowledge of another chapter is required before starting a chapter. Also, there is an elaborated table of contents and an index, to locate subjects quickly.

The presentation of the subject material is based on the principle that the student should be able to study the theory independently. For purpose of self-studying, many examples are provided. The student can also assess with the aid of test questions, whether the material is understood. To allow the student to verify his/her answers, the answers to the test questions can be found at the back of the book. To illustrate the practical relevance of the discussed theory, explanatory texts with photos, newspaper cuttings and fragments of financial statements have been included.

Key terminology is emphasized by including it in the margin. Each chapter concludes with a glossary and multiple-choice questions. The answers to the multiple-choice questions are at the back of the book.

The theory can be tested with the aid of the assignments in the *Exercise book*. The exercises are sorted by degrees of complexity. In the *Answers and Solutions* a number of exercises is discussed in detail.

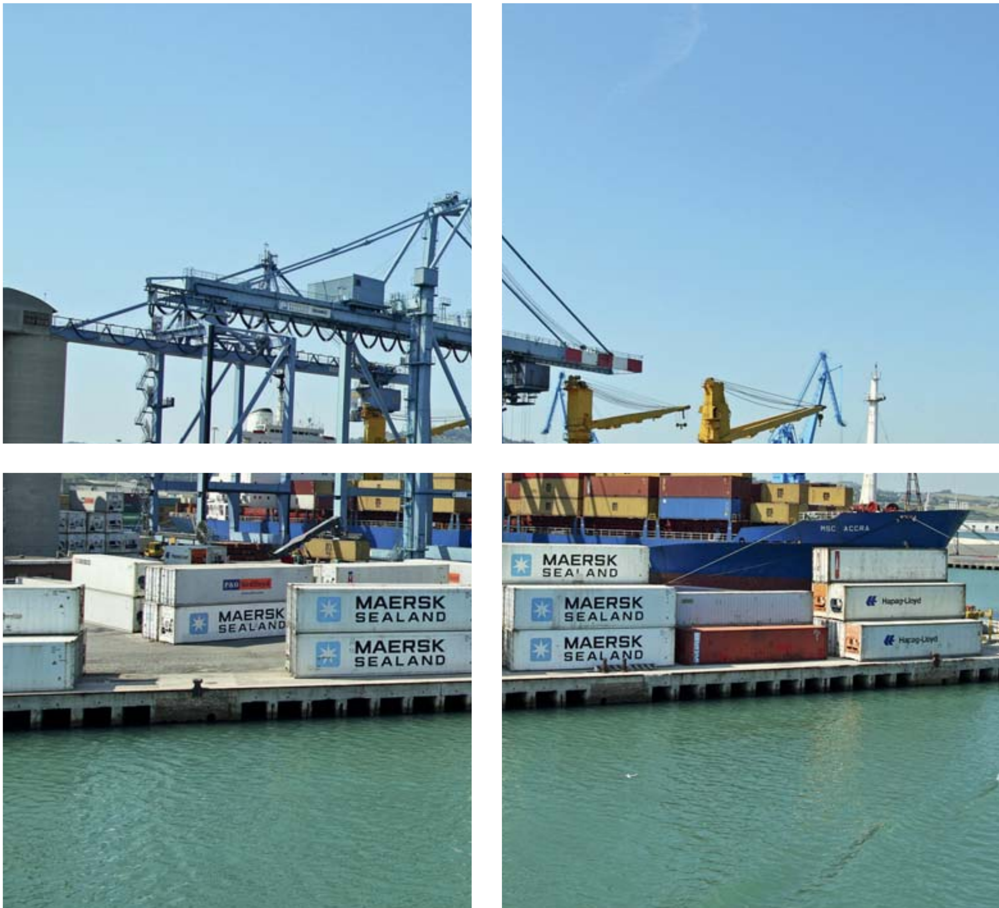


Flexible learning routes
On reading the introduction, it can be concluded that for studying all the material in this book, different learning routes can be distinguished. The first route follows the sequence of the subjects in this book, firstly dealing with Finance, then Management Accounting and finally Financial Accounting. This order has the preference of the authors as it matches the consecutive problems that an entrepreneur faces.

In the second major route, the part Management Accounting is studied first, followed by Financing and Financial Accounting. This is the more traditional sequence used in the field of financial management, first focusing on the issues concerning cost calculations.

In principle, it is also possible to start with Financial Accounting after the first introductory part. It is a rather unusual approach when studying all the topics, however the set-up of the method allows this route also.

PART 1
Financial management in business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1 Businesses and their role in the economy

A company can be defined as a production organization aiming to make profit; paragraph 1.1 discusses the various elements of this definition. The essential difference between companies and non-profit organizations is described in paragraph 1.2, where it will become clear that financial management techniques are also applicable to non-profit organizations. In paragraph 1.3, business activities are divided into four major types of business: agriculture and mining, manufacturing, trade and services. The choice of activity will determine the nature of the resources required by the company. Companies require a legal form to be able to conduct business. The legal form is important for, among others, liability of the owner for the company's debts, and for its fiscal position. Paragraph 1.4 will further elaborate on this. Paragraph 1.5 discusses value added tax, which all entrepreneurs have to deal with. Finally in paragraph 1.6, different forms of co-operation between companies are discussed, varying from completely abandoning autonomy to forms of co-operation that leave the autonomy largely intact.

1.1 Consumers and manufacturers

People need many things: a house, food, a car or bicycle, assistance with completing their tax return, a form of leisure such as a weekend break, etc. All these products and services have to be 'manufactured'. To make use of a car, a car manufacturer is required; to allow a weekend break, there has to be a hotel. Prior to large-scale barter, every consumer was also a manufacturer: he baked his own bread and built his own house. In developed economies this is no longer the case.
Enterprises, further referred to as production companies, manufacture products and services and offer these to consumers at a price. The consumer has purchasing power due to the income generated by working for these companies.
Economics deals with questions connected to the optimization of 'prosperity': how can the supply of products and services be optimized, i.e. using minimum resources?

Economics

Economics studies the relationship between consumers and companies and these companies' mutual interactions. A distinction can be made between micro and macroeconomics. Microeconomics comprises among others, the theory of markets: how does the price mechanism work in a particular market, for example the market for holiday travel? Determining for this, are among others, the number of suppliers and customers in that particular market. In paragraph 1.6, markets will be briefly discussed. *Macroeconomics* investigates economic problems that affect society as a whole, such as inflation and unemployment.

Business economics

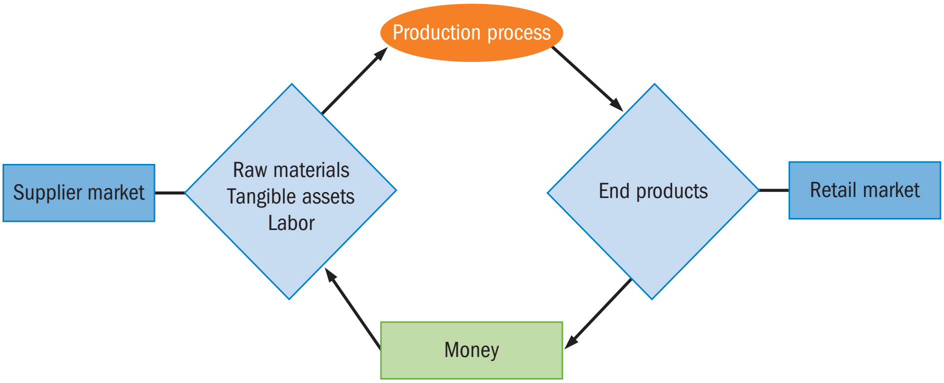
Business economics focuses on economic behavior in a production organization. 'Production' should be interpreted broadly: it not only concerns the production of physical goods but also trade and services. For example in economic terms, a production organization is not only an auto plant but also an auto dealer and a mechanic. In paragraph 1.3, the different forms of production are discussed.
The economic system assigns an important role to production by entrepreneurs. Companies are production organizations that focus on earning income for their owners 'on the market'. They are therefore, production organizations in pursuit of profit. A further discussion of two important elements in the definition of a company will follow.

A company is a production organization

In a production organization, resources are combined and transformed into end products during the production process.
A production organization operates between two markets: the supplier market where resources are obtained and the retail market where manufactured goods are sold.
The resources can comprise commodities/nature on the one hand and machines, buildings and so on, on the other. The latter are called tangible assets or non-current assets, as they – compared to raw materials – remain

in the company for a long period of time. Labor, supplied by the company's employees, is of course also a resource.
Figure 1.1 shows the schematic production process.

FIGURE 1.1 Production process



EXAMPLE 1.1

A brewery buys hops and water and converts these through a series of processes into beer. The water and the hops are the commodities for the end product: beer. In addition to commodities, the company must have tangible assets: a building, boilers for beer preparation, trucks, computers, etc. Of course, employees are an indispensable link in the production chain.

The production organization is thus a joining of the production factors, particularly labor and capital. 'Capital' refers to the raw material and the tangible assets used by the company.
The production organization can have a formal nature, with all rights and obligations of the participants laid down in writing: the empowerment of shareholders, directors and employees will be described in the articles of association and in the job descriptions. A production organization can however, also comprise two students starting a courier service, with the only agreement being that they will take turns in answering the phone and making deliveries by scooter.

TEST QUESTION 1.1

The owners and employees are the direct participants in a company. Broadly speaking, there are more participants who have an interest in the company's success.
Name some other participants.

1

A company seeks to maximize its profit

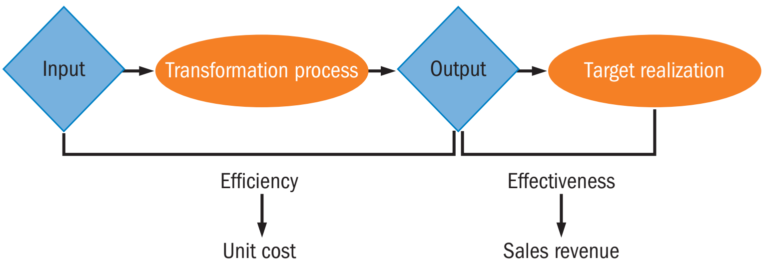
A company participates in the economic process to make the owners "better off". It strives for "value creation": the sales of the produced goods and services will have to outweigh the price paid for the production factors (labor, raw material, tangible assets) at the supplier market. The owners of the company will be the beneficiaries of the paid surplus, the profit. Seeking maximum profit is what distinguishes companies from enterprises in general. Every enterprise produces goods and/or services. In the following paragraph, enterprises without a profit target will be described.

Efficiency
Effectiveness

The level of profit depends on efficiency on the one hand and effectiveness of the business process on the other. *Efficiency* relates to the cost-effectiveness of the production process and *effectiveness* to meeting the target objectives of the production process, or the level at which the end product meets the customer requirements. A production process is efficient if a given quantity is produced at minimum costs. A production process is effective if the end product is appreciated by customers and customers are willing to pay for it.

EXAMPLE 1.2
The brewery in example 1.1 strives to produce a hectoliter of beer by using labor and tangible assets as efficiently as possible. The company will try to achieve the given quality standards at minimum cost. The cost is therefore a measure for efficiency.
The end product should be of such nature that the company acquires a market share. The taste of the beer, the price-quality ratio and its positioning through commercials should contribute to this. The effectiveness is determined by the level of success at which the brewery generates sales. In figure 1.2, the role of efficiency and effectiveness in the production process is shown.

FIGURE 1.2 Efficiency and effectiveness in the production process



It is characteristic for a company to use profit as a measure for efficiency as well as effectiveness: after all it is the difference between sales (measure of effectiveness) and costs (measure of efficiency).
Maximizing profit is a company's priority; the manner in which this profit is acquired is of secondary importance. If a shipping company establishes that the shipping business no longer has profit prospects, the company will in principle not have any problem with switching to a different activity.

Although some employees will regret the loss of a rich piece of shipping history, financial considerations will prevail. Profit is the target, the activities are a means to an end.

Following additional remarks can be made:

- Maximizing profit 'at all cost' is usually not given highest priority. Continuity of the company is also an important concern. Profit is however, necessary to assure continuity; only then will a company have the required financial resources to survive independently. Considering a company's continuity, a long-term perspective towards profit targets is also necessary: making 'a fast buck' by offering inferior products as top quality, will work counter-productively in the long run. **Continuity**
- Nowadays, companies often present a *mission statement*, outlining their targets. Profit is usually not a prominent factor, unlike environmental issues, job satisfaction for employees, etc. Such a statement can of course also be used as window dressing. **Mission statement**

Mission
Improving people's lives through meaningful innovation.

Vision
At Philips, we strive to make the world healthier and more sustainable through innovation. Our goal is to improve the lives of 3 billion people a year by 2025. We will be the best place to work for people who share our passion. Together we will deliver superior value for our customers and shareholders.

Source: Philips

- It sometimes appears as if not maximizing profit but maximizing sales is the major company target. For company directors often 'the bigger the better' seems to prevail. Companies are for example taken over, without a decision being based on well-founded expectations of generating additional profit.

1.2 Profit and non-profit organizations

Companies focus on maximizing profit and are part of the profit sector. In this book, attention is focused particularly on this sector. The Netherlands however, also has many non-profit organizations. A distinction can be made between public and private non-profit enterprises.

- the *public sector* comprises the State, provinces, municipalities and regional water authorities. The government provides mainly *public goods and services* for the general public, such as infrastructure, sea defense and safety. These facilities cannot be provided by private enterprises due to failure of the *market mechanism*: consumers cannot purchase a small piece of sea defense to protect themselves against the tide. Hence, the *budget mechanism* is applied to produce public goods and services: the government imposes compulsory **Market mechanism** **Budget mechanism**

contributions (tax) and provides a budget to finance the production of public goods.
There are also general facilities, which in the past have been offered by the government to influence their availability to a larger public, but in principle could be provided by companies. In recent years, the government has supported a trend towards *privatizing* these activities: where applicable, these activities are separated from government and must prove themselves on the market. Examples are public transport, telecommunication, mail delivery and the supplying of energy.

1

Privatizing

- The *private non-profit enterprises* comprise a wide variety of organizations: amateur sports clubs, but also charitable organizations such as the Red Cross. The latter is also known as a fund-raising institution since it attempts to raise funds to achieve a worthy social objective.

Organizations in the non-profit sector differ from companies by the following aspects:

- Non-profit organizations have a target to provide certain (socially important) facilities. The activities they perform are connected to their social objective. Médecins sans frontières/Doctors without Borders provides medical activities in developing countries because it is its reason for existence. To change activities based on financial-economic reasons is not on the agenda. Donors would strongly object if the organization would suddenly switch to other activities. Shareholders of a profit organization such as Unilever will not lose any sleep if the manufacturing of laundry detergents is replaced by another activity with higher profit prospects.
- Non-profit organizations cannot exist by conducting business transactions and are – in contrast to companies – not economically independent. They depend on “free gifts” such as contributions, subsidies, inheritances, etc. To some extent, a non-profit organization can also operate on the market, for example by selling T-shirts with a logo.
- The assessment of the effectiveness of non-profit enterprises is much more difficult than that of a company. As established earlier for the latter, profit is an indication of both effectiveness and efficiency during production. Obviously, profit cannot be used as a key indicator in the non-profit sector.
  A foundation focusing on victim aid is effective if it succeeds in solving as much as possible, the problems of its clients. This cannot be expressed in money. The effectiveness must be established in another way, for example by registration of waiting time and by conducting a client satisfaction survey. Non-profit enterprises can monitor their efficiency by calculating their costs. The foundation for victim aid for example, could calculate the costs of a one-hour consultation.

The subjects discussed in this book are mainly applicable to companies, although they are also relevant for non-profit enterprises. This applies in particular to the subjects in the management accounting part, as non-profit enterprises will also attempt to work as efficiently as possible.
In the Finance part, a number of the discussed financial resources, such as shares, only applies to companies. Other subjects are also applicable to non-profit organizations.

Financial reporting, as discussed in the Financial Accounting part, can also be applied to non-profit organizations, although making profit does not automatically imply that the organization performed well, as profit is not a primary objective in the non-profit sector.

Statement of activities World Wildlife Fund Inc 2013 (year ended June 30) in $

Operating activities revenues	
Contributions	131,890,374
Government grants and contracts	48,219,397
WWF network revenues	16,210,347
Other revenues	69,971,451
Total revenue and support	266,291,569
Operating expenses	
Conservation field and policy programs	144,381,532
Public education	81,737,392
Finance and administration	12,352,154
Fundraising	27,664,528
Total operating expenses	266,135,606
Revenue and support over operating expenses	155,963

Source: WWF Annual report 2013

TEST QUESTION 1.2

The results for WWF in 2013 were positive. Why can you not automatically conclude that WWF performed well in 2013?

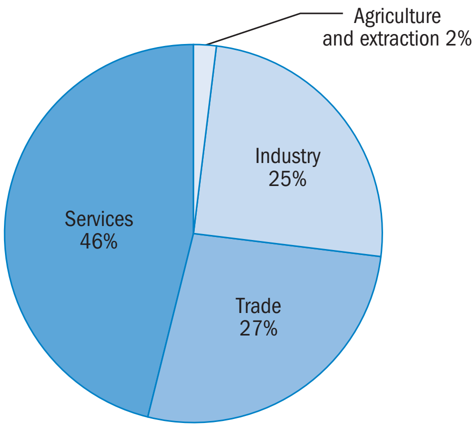
1.3 Business activities

In paragraph 1.1, a company was described as a production organization focused on profit. The company aims to generate profit by purchasing resources and converting these into goods or services that are sold at a higher price than the purchase price.
Following classification is based on the nature of the transformation process:
- agriculture and mining
- industry
- trade
- services

Figures 1.3a and 1.3b provide an overview of the four sectors in terms of their stake in the overall European and Dutch economy.

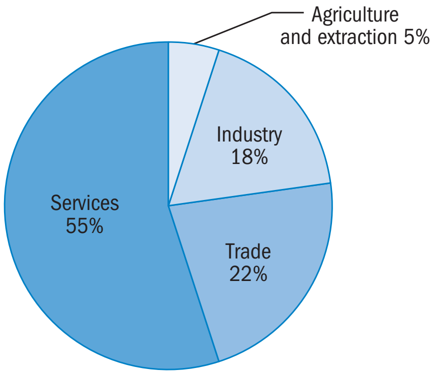
1

FIGURE 1.3a Number of companies per sector in Europa (2010)



Source: Eurostat

FIGURE 1.3b Number of companies per sector in the Netherlands (2013)



Source: CBS

Agriculture and mining

Companies in the agriculture and mining sector typically use the 'wealth of nature'. With a relatively small quantity of commodities, a large quantity of end product is achieved. To a farmer, the cost of seeds are merely a small percentage of the crop sales. Mining companies involved in extraction of mineable minerals, such as gold or copper and commodities such as gas or oil, do not use commodities at all, as they produce them. Obviously, assets are nevertheless very important: farmland for the farmer, a concession for the mine or the oilfield of an extraction company; also a lot of equipment can be required.

Industry

Job production

Industrial organizations create a physical, tangible product that did not exist before production. A distinction between mass and job production can be made. In *job production*, production is customized. Each product is tailored

to the customers' requirements and the product is made to order: there is a sale before production starts.
There is no build-up of inventories of finished but unsold products in job production. An example of job production is a shipyard where pleasure yachts are built to customer's specifications.
In *mass production* one type of product is produced in large quantities (flow production). Specific customer's requirements are not considered. There is usually a build-up of inventory. A sugar refinery is an example of mass production.

Mass production

Table 1.1 summarizes the differences between mass and job production.

TABLE 1.1 Differences between mass and job production

Job production	Mass production
Customized product	Standard product
Intended for one particular customer	Intended for the 'market'
Made to order	Made for build-up of inventory

Between the two extremes (mass and job production), there are intermediate production processes that generate a series of identical (half) products *(batch production)*.
In a *batch-job production process,* the idea is that every customer gets a particular individual product but costs are saved by producing the components in larger quantities (and therefore cheaper). If the previously mentioned shipyard produces various types of hulls, masts, cabins and other items in series and the customer can choose from the available components to create his own 'dream boat', this is considered as batch-job production.
In a *batch-mass production process*, a variety of models of the standard product are produced, and every so often the machines are adjusted to produce a different variant. If a sugar refinery not only produces granular sugar but also switches to sugar lumps now and again, this is considered as batch-mass production.

The importance of the three resources (raw material, tangible assets and labor) varies, depending on which type of industry a company operates in. For an oil refinery, commodities and tangible assets will be a major part of the costs, whereas labor costs will be a prevailing factor for a manufacturer of artisan wooden kitchens. As automation progresses, the significance of tangible assets in the total cost increases.

Trade

Trading companies do not produce new products. There is no transformation process in the technical sense. Trading companies derive their existence from the fact that there is an imbalance between production and consumption. This imbalance can be related to:
1 the scale of production and consumption;
2 the composition of production and consumption;
3 the moment of production and consumption;
4 the location of production and consumption.

1

EXAMPLE 1.3

For a Japanese manufacturer of computers, it is problematic to sell computers directly to Dutch consumers. Trading companies solve this problem. A chain of computer stores can import many computers from Japan (1), and add other articles the customers could need to its product range (2), build-up an inventory to allow the customer to buy a computer at any given time (3), and offer its goods close to where the consumer lives (4).

Retail trade

Wholesale trade

The transformation process in a trading company relates to transformation in scale, product range, time and place. For trading companies, a distinction can be made between the wholesale and retail trade. *Retail trade* is the final link in the chain; the retail trade supplies directly to the end user: the consumer. *Wholesale trade* purchases from the manufacturer and redistributes the purchased goods amongst the retail trade. The wholesale trade is characterized by 'business-to-business': both suppliers and customers are companies. To be able to fulfill an independent function in the economy, the wholesale trade's strength has to be in delivering the right products at the right time to the store. This requires important investments in logistic systems. The trading costs consist mainly of the purchased merchandise. Apart from this, of course other tangible assets are also involved (buildings, cars, and so on). Labor costs can also be considerable, particularly in retail trade.
Due to the Internet there are major shifts in trade. In particular, retail trade is under pressure. The wholesale trader can offer his products directly to the customer through Internet stores.

Services

Service companies provide a service to their customers without manufacturing a new product or redistributing an existing one. This applies to companies of a varied nature.
Some important categories:

- financial services (banks, insurance companies);
- hospitality industry;
- transport;
- IT-services (software firms, computer consultancies);
- facility services (security, catering, cleaning).

Typical for the service industry is that no (or hardly any) raw material is purchased from suppliers. Tangible assets can be very important for service companies: consider the hotel located in the center of Amsterdam or a shipping company with a fleet of container ships.
Labor costs are nearly always very important; service rendering is a 'people business': consider IT-specialists working for a software company or security guards at a security firm.

In container shipping, tangible assets entail significant costs. It requires approximately €150 million to have a large container ship built.
Labor costs are significant. By operating larger ships, shipping companies attempt to reduce the burden of labor costs. In principle, a large ship does not require a larger crew. For large ships, labor costs for each transported container are therefore less.

The Danish shipping company A.P. Møller – Maersk Group holds a major share of the global container market through its subsidiaries Maersk Line and APM Terminals. In 2013 Maersk took the first of a new class of container ships in service. The triple-E ships are currently the largest in the world, with a length of 400 meters. A ship can carry 18,000 20-foot containers. Due to extensive automation, a ship only requires thirteen crewmen.

TEST QUESTION 1.3

The cost ratios of three internationally operating Dutch companies are mentioned below:

	1	2	3
Raw materials	80%	73%	0%
Labor costs	7%	14%	96%
Other costs	13%	13%	4%
Total cost	**100%**	**100%**	**100%**

These three companies are:
- Ahold, supermarket chain
- Randstad, temporary employment agency
- Royal Dutch Shell, manufacturer of oil products

Which number relates to which company?

1

1.4 Legal forms of businesses

A company has a legal form. The choice of the legal form determines the legal relationships within the company and between the company and the outside world.
Important aspects that are determined by the legal form are:

- Who has the ultimate say in the company?
- How can the company attract financial resources?
- What guarantees are there to ensure long-term continuation of the company?
- To what extent are the owners liable for the debts incurred by the company?
- What is the company's fiscal position?
- To what extent is the company obliged to disclose its financial results?

Legal entity

Companies can be divided into two major categories, companies with a *legal entity* and companies without. A company operating as a legal entity is considered as an independent party in legal agreements made during business transactions. It can hire staff, conclude a sales agreement and borrow from the bank. Of course private individuals are required to conclude such an agreement on behalf of the legal entity.
If a company is not a legal entity, the agreement will be made in name of the owner.

If a company is not a legal entity and is the property of one individual, it is called a sole proprietorship. If there are several owners and the company is not a legal entity, it is called a partnership.
In the US, companies with a legal entity (separate from the owners) are called 'business corporations'. In the Netherlands there are three types of companies with a legal entity: nv, bv and cooperative.
In the US, business corporations can also be non-profit organizations. In the Netherlands there are two different types of non-profit organizations: foundation and association. In the Netherlands, foundations and associations are both legal entities. An elected board acts on behalf of the organization. These legal entities will not be further discussed in this book.
In the course of this paragraph the consequences of the different legal forms will be explored.

Sole proprietorship

In a sole proprietorship the owner is also the management. He is the owner because he provided the capital to run the company. It is possible that the owner has not only invested his own capital but has also taken out a loan. However, this does not give the lender (usually a bank) control of the business. Of course, several persons can work in a company with sole proprietorship, although these will be members of staff employed by the owner.
A sole proprietorship depends entirely on the entrepreneur. If he is incapacitated, the company ceases to exist. This implies that the continuity of the company is uncertain in the long run. If the entrepreneur is no longer active in his company, a successor must be found, either among relatives or outsiders.
As previously discussed – and discussed in detail in the financing part – the company can be financed with capital invested by the owner or by loans.

Equity
Liabilities

The first method of financing is called *equity*, the second method is called *liabilities*.
The size of the sole proprietorship will normally be limited, due to the limited availability of equity.
When the company is set up, the owner must invest private assets. Strengthening the company's financial position can be acquired by retaining profits. This implies that profits cannot be used for private purposes by the owner but must remain in the company.
As it is the entrepreneur in his personal capacity and not the company who enters into legal agreements, the entrepreneur is liable for the debts incurred by the company.

1

EXAMPLE 1.4

A starting entrepreneur has invested his savings in a hairdressing business. He borrows the remaining required capital from the bank. The business fails to attract enough customers. The entrepreneur cannot meet his interest and principal sum repayment obligations to the bank. The styling chairs and further store inventory are sold, however the proceeds are low. The bank will demand a further investment of private assets from the proprietor to clear the debt. Under extreme circumstances this could result in his car or house being sold.

The entrepreneur pays income tax on the profits made by the sole proprietorship. Most European countries have a progressive income tax system with increasing tax rates for higher incomes above a certain threshold. Entrepreneurs can usually enjoy certain fiscal advantages and reduce their taxable income through deductions or receive reductions on the payable tax.
This is explained in the following example, based on Dutch income tax law.

The Dutch income tax system has three different tax boxes. Income is taxed progressively in box 1, including social security (in particular as a consequence of the General Old Age Insurance Act). In box 2, all income deriving from substantial shareholding (see also company with share capital) and box 3 all income deriving from savings and investments. As profit acquired by the sole proprietorship is considered fiscally as income of the entrepreneur, profit will be taxable in box 1.

Box 1 Income tax rates (2014)

Tax bracket	Taxable income	Percentage
1	Up to €19,645	36.35%
2	As of €19,646 up to €33,363	42%
3	As of €33,364 up to €56,531	42%
4	As of €56,532 and higher	52%

1

Entrepreneurs are entitled to various fiscal advantages. One of the favorable arrangements is the *self-employed tax deduction*, allowing entrepreneurs to deduct an amount from their profit. In 2014 the self-employed tax deduction was €7,280. For any profit above this amount, 14% (2014) is exempt from taxation.

Furthermore, every taxpayer liable for income tax is entitled to a reduction on the amount of tax to be paid. The general tax credit amounts to €2,103 (2014), and further granting everyone with income deriving from work, an additional labor tax credit. The labor tax credit is based on taxable income. For the entrepreneur this is profit prior to self-employed tax deduction.

Labor tax credit (2014)

Income Above	Income not above	Labor tax credit
–	€ 8,913	1.807% × income
€ 8,913	€19,248	€ 161 + 18.724% × (income – €8,913)
€19,248	€40,721	€2,097
€40,721	€83,971	€2,097 – 4% × (income – €40,721)
€83,971	–	€ 367

Furthermore, there are for example reductions for single parents.

Schematically, the calculation of tax due from the entrepreneur is as follows:

	Profit	
–	Self-employed tax deduction	
	Profit after self-employed tax deduction	
–	Profit exemption	(14% of profit after self-employed tax deduction)
	Taxable profit	
	× Rate	(according to table)
	Tax amount	
–	Tax credit	
	Actual amount of tax payable	

TEST QUESTION 1.4

Van Dam has a sole proprietorship in the Netherlands and acquires a profit of €40,000.
He has no other income. Calculate the actual amount of tax he has to pay.

Accounting obligations

All entrepreneurs have a legal obligation to maintain an administration; these *accounting obligations* allow the tax authorities to inspect the company's tax returns.
The owner of the sole proprietorship is not obliged to disclose any financial information, and the sole proprietorship has no *disclosure requirements.*

The partnership

If two or more persons decide to work together in business without a legal entity, this is called a partnership. There are partnerships for professionals such as doctors, lawyers, accountants, etc. and there are partnerships trader-to-trader and manufacturer-to-manufacturer. For further discussion, the participants of the partnership are referred to as partners. Unless otherwise stated, everything discussed applies to both the professional partnership as well as the partnership of trader-to-trader or manufacturer-to-manufacturer.

The control of the business is held by the joint partners. The advantage of a partnership is that each partner has his own specific expertise and mutual consultation can result in better decisions. The downside is that more than one captain on a ship can result in differences of opinion. This will influence the odds for continuation of the partnership. On the one hand, the loss of a partner is not necessarily fatal for the business, but differences of opinion can on the other hand lead to a premature ending of the business.
It is possible to acquire extra equity by offering a new partner the possibility of buying himself into the business.
The partnerships trader-to-trader and manufacturer-to-manufacturer have separated capital, which implies that business creditors have priority over private creditors in the event of defaults.
The partners are *jointly and severally liable* for the debts of the partnership. This implies that a creditor can demand payment in full from either partner. **Jointly and severally liable**
In the Netherlands there is a difference in liability between professional partnerships and partnerships trader-to-trader or manufacturer-to-manufacturer. The partners in a professional partnership are not jointly liable for the entire debt but are severally liable for an equal share of the debt.

EXAMPLE 1.5
The partnership Smith & Jones trades in antiques and curios. Both partners hold an equal stake in the partnership. The partnership has bought a shipment of antiques for an amount of €50,000. The bill has not yet been paid. Due to a downturn in the economic situation, the sales of this shipment are only €30,000. There are no other assets in the partnership.
The importer is now entitled to demand for example, the remaining €20,000 from Smith. Smith is left with the problem of claiming half of this amount back from Jones.

The partnership is not acknowledged by the tax authorities. Each partner is assumed to run his own business (for the amount of his or her profit share). The income tax is based on this profit share. The partners are also entitled to the same fiscal advantages as the owner of the sole proprietorship. The partnership is not obliged to disclose financial information.

Limited partnership
The general partnership is run and owned by the same persons. The *limited partnership* has a partial separation of ownership and control: the limited partners can be owners of the business because they invested capital but they are not controlling the business. The general partners in the limited

partnership are both owner and are controlling. An advantage of the limited partnership is the opportunity to attract extra capital without the risk of disputes among partners. The limited partners are not liable with their private assets, for the debts of the business. The limited partners also pay income tax on their share of the profit. Unlike the general partners however, they are not entitled to the tax advantages granted to sole proprietorship.

Joint-share companies

A joint-share company is a legal entity with limited liability. In the United States, the Limited Liability Company (LLC) and the Business Corporation are examples of joint-share companies. Public Limited Company (PLC) and the Limited Company (Ltd) are joint-share companies in the United Kingdom. In the Netherlands, typical joint-share companies with limited liability are the limited liability company (bv) and public liability company (nv). In the Netherlands a legal separation is made between ownership and control. Firstly, the mutual characteristics of the limited liability company and public liability company in the Netherlands will be discussed, followed by the differences between these two joint-share companies.

Shares

The equity of the joint-share company is divided into *shares*. The annual general meeting of shareholders (AGM) is the highest authority in a joint-share company. All important decisions, such as appointing the board of directors, are made during the annual shareholders meeting.

The board of directors handles daily management.
One of the differences between an LLC and a PLC, is the involvement in daily business of one (or several) shareholder(s) at an LLC. At LLCs, arising from a sole proprietorship or a partnership, one or more major shareholders (the previous owners of the company) often hold a position on the board of directors, thus being managing director and shareholder.
A PLC is usually set up with the purpose of gathering large capital. There will be many shareholders who will not be involved in the day-to-day business management, however, larger LLCs can also make a clear separation between ownership and control.
It is possible that, besides the AGM and the Board of Directors – there is a third body: the Supervisory Board (SVB). The SVB supervises the board of directors on behalf of the shareholders.
Both the LLC and PLC can acquire additional equity if the AGM decides to pass dividend payments and retain the profit. It is also possible to issue additional shares. Due to the separation between control and ownership, the company's continuity is better guaranteed. The shareholders have limited liability. They cannot be obliged to compensate the company's debts with their private assets.

The taxation of the profit of LLC and PLC is rather complicated, as both the company and the shareholders are taxed. Corporate tax is imposed on the profit of both the LLC and PLC. Shareholders pay income tax on their share of the profit.

Each country applies its own rules concerning corporate tax. The two main systems are the classical tax system and the imputation system. Under the classical tax system the company pays corporate tax on the profit and the shareholder pays income tax on the dividend. As a result, all dividends paid will be taxed twice. Under the imputation system the company pays corporate tax, which is considered to be tax paid on behalf of the shareholder. The shareholder pays income tax on his share of company profit and can deduct the tax that was already paid on his behalf from the amount of income tax he has to pay. The difference between the two systems is illustrated by a simplified example.

EXAMPLE 1.6

An LLC generates €100,000 profit before tax. The entire profit after tax is paid to the shareholders. The corporate tax rate is 20%, the income tax rate is 25%.
Under the classical system the corporate tax and the income tax are applied independently. The LLC pays €20,000 in corporate tax. The profit after tax is €80,000. This profit is paid to the shareholders, who pay €20,000 income tax on this amount. The total amount of tax paid is €40,000.
Under the imputation system there will also be €20,000 corporate tax, however this can be deducted from the income tax of the shareholders. The income tax for the shareholders will amount to €25,000 over the total profit before tax. As the LLC already paid €20,000, the shareholders will only have to pay the remaining €5,000. The total amount of tax paid is now €25,000.

In the Netherlands, the classical tax system is applied. The corporate tax rate in the Netherlands is given in the following table.

Corporate tax rates (2014)

For the taxable amount	Rate
up to €200,000	20%
above €200,000	25%

The shareholder pays income tax. In the Netherlands, a distinction is made between shareholders who own at least 5% of the share capital and shareholders who do not.

Substantial business interest holder

A shareholder of the first category, is considered to be a *substantial business interest holder*. He will be taxed in box 2 of the income tax (rate 2014 22% up to €250,000 and 25% for everything above that amount) on the dividend that he will receive from the company and for possible profit on share sales. This implies that on each euro profit at least 37.6% tax will be paid: firstly by the company paying 20% corporate tax on the profit, and additionally by the shareholder, 17.6% income tax (22% of 80%). In total, resulting in 37.6% tax.
The LLC only has often one shareholder, who then becomes the managing director and sole shareholder. The salary of the managing director and shareholder is a cost to the company and deductible for corporate tax. However, the managing director and shareholder must pay income tax on his salary. The dividend received by the managing director and shareholder is not a cost but profit distribution, taxed in box 2.

1

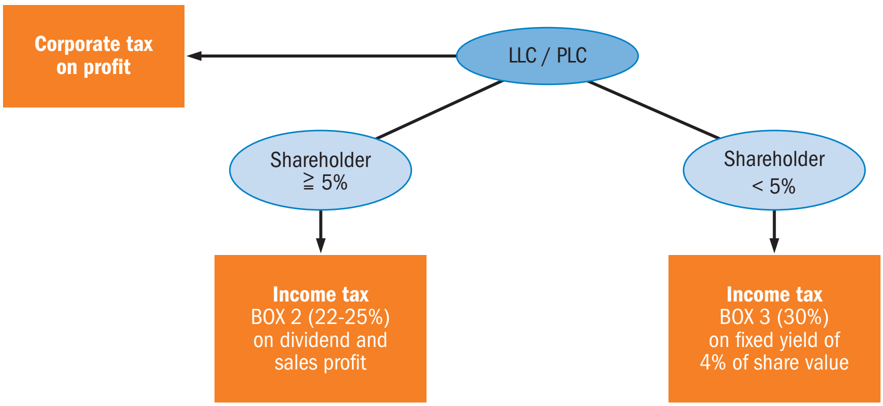
A shareholder with less than 5% of shares will be taxed in box 3 of the income tax system. In this box it is assumed that the income deriving from investments such as shares is always 4% of the investment value. The actual revenue is not important. The assumed revenue is taxed at 30%. For small investors this results in a taxation of 1.2% (30% of 4%) of the share value.

EXAMPLE 1.7

Shipping agent Ferry LLC achieves an annual profit of €120,000, of which €80,000 is paid in dividend to its shareholders. The shareholders of the company are J. Zalk (with 97 shares) and P. Hasseldorf (with 3 shares). The market value of share per unit Ferry LLC is €25,000. The LLC pays corporate tax over €120,000, being:
20% of €120,000 = €24,000.
J. Zalk is a substantial business interest holder; he will have to pay income tax on €77,600 (97% of €80,000). In box 2 this amount will be taxed at 22%, being €17,072.
The dividend of P. Hasseldorf will be taxed in box 3. He will have to pay 1.2% over his share value of €75,000, being €900.

The fiscal position of both company and shareholders is presented in figure 1.4.

FIGURE 1.4 Fiscal position company and shareholders



In the event of dividend payment, the company must withhold 15% dividend tax and pay it to the tax authorities. This does not increase tax pressure, as the shareholder can set the paid dividend tax off against the income tax he has to pay.

Both the LLC and PLC have disclosure requirements. This implies that they have to publish their financial reports by filing them at the office of the

Trade Register, where interested parties can consult them. The Chamber of Commerce maintains the Trade Register.
The amount of information that must be disclosed, depends on the company size; this will be further discussed in chapter 15.

Differences between LLC and PLC

The three major differences between both forms of joint-share company:
1 LLC's shares are always *registered shares.* For a PLC it is possible to issue *bearer shares*, and changing of legal ownership is easy. Stock exchange listed companies are therefore always PLCs.
2 An LLC can enter a *blocking clause* into the articles of association, putting restrictions on selling shares. The shareholder could for example, be obliged to offer his shares first to the other shareholders. A PLC cannot restrict the sale of shares.
3 For the set-up of a PLC an initial minimum capital of €45,000 is required. There is no required minimum capital for setting up an LLC.

Blocking clause

Although regulation varies per country, every country has company forms similar to the LLC and PLC. The following overview gives the names of the legal form that most closely matches the LLC and PLC for each country.

Country	Similar to LLC		Similar to PLC	
Denmark	Anpartsselskab	ApS	Aktieselskab	A/S
France	Société à responsabilité limitée	SARL	Société anonyme	SA
Germany	Gesellschaft mit beschränkter Haftung	GmbH	Aktiengesellschaft	AG
Italy	Societa a responsabilita limitata	Srl	Societa per Azioni	SpA
Japan	Godo kaisha	GK	Kabushiki kaisha	KK
Spain	Sociedad Limitada	SL	Sociedad Anónima	SA
The Netherlands	Besloten vennootschap met beperkte aansprakelijkheid	bv	Naamloze vennootschap	nv
United Kingdom	Limited liability company	LLC	Public limited company	PLC
United States	Limited liability company	LLC/ Co.Ltd	Corporation or Incorporated	Corp.Inc.

Cooperative

A cooperative acts on behalf of its members. The members of a cooperative do business with their cooperative. The nature of this business can vary:
1 At a *production cooperative*, the members are suppliers of raw material for the production process. In a cooperative dairy, the farmers will supply the milk, in a sugar refinery they will supply the sugar beet.
2 At a *purchasing cooperative,* the members buy their supplies from the cooperative, such as seeds, propagating material or fertilizer.
3 A *cooperative bank* lends money to its members.

If insurances are sold to members, the insurer is called a *mutual association*; which strongly resembles a cooperative.

Mutual association

In the cooperative, the members are the highest authority. The management is nominated by the members and is responsible for day-to-day business. In some cases there is a supervisory board, whose function resembles that of the supervisory board at an LLC and PLC.

TEST QUESTION 1.5

The bond between the members and the cooperative is usually much tighter than that between shareholders and their PLC. What could be the reason for this?

Cooperatives can mainly be found in the agricultural and financial sectors.

The financing of cooperatives can be difficult. There is no share capital. Retaining profits is a sensitive subject as making profits would imply that the cooperative has paid its members lower than market prices (when it concerns a production cooperative) or above market prices (when it concerns a purchasing cooperative). To meet requirements for extra capital, it is possible to issue 'member certificates' with the characteristics of long-term loans. The continuity of the cooperative is guaranteed because members cannot suddenly leave the cooperative. Members can also be obliged to deal only with the cooperative.

Like shareholders of an LLC or PLC, members of a cooperative usually have limited liability for the debts of the cooperative. In the Netherlands there are three legal forms of cooperative:

1 *Legal liability:* the members are liable for the debts of the cooperative.
2 *Excluded liability*: the members cannot be obliged to pay the cooperative's debts.
3 *Limited liability*: the members are responsible for the cooperative's debts up to a maximum amount per member.

The cooperative is taxed in accordance with the corporate tax system; however there is a special arrangement that prevents all profit from being taxed. If the members are entrepreneurs, any profit payments will be taxed according the income tax law in box 1.
There are disclosure requirements for the cooperative.

In table 1.2 the characteristics of the different legal forms are summarized.

TABLE 1.2 Overview of consequences of legal forms for companies:

Type of company	Legal entity status	Separation control and ownership	Financing with private assets	Continuity	Liability	Fiscal position in the Netherlands	Disclosure requirements
Sole Proprietorship	No	No	Deposit private assets by owner	Stands or falls with the owner	Fully liable	Entrepreneur: income tax box 1	No
Partnership	No	No	Deposit private assets by partners Acquisition of a partner share	Departure of a partner can be compensated by other partners, possibility of conflicts	Several liability (equal share)	Partners: income tax box 1	No
Limited partnership	No	Yes	Deposit private assets Acquisition of business share by new general or limited partner	Less possibilities for conflicts because capital can be attracted without adding a leader	General partners: several liability Limited partners: total amount of contribution of private assets	Partners: income tax box 1 Limited partners: without entrepreneurs benefits	No
LLC	Yes	Yes	New issue of shares to current shareholders (blocking clause)	In principle, independent existence as legal entity but in the event of manager/ shareholder owner strong dependency	Limited to amount of contribution of private assets	LLC: corporate tax Main shareholders: income tax box 2	Yes
PLC	Yes	Yes	new issue of shares	Independent existence as legal entity	Limited to amount of contribution of private assets	PLC: corporate tax Shareholders: income tax box 3	Yes
Cooperative	Yes	Yes	Member certificates	Independent existence as legal entity	Legal, excluded or limited liability	Cooperative: corporate tax (special arrangement) Members: income tax box 1	Yes

1

1.5 Value added tax

In paragraph 1.4 – during the discussion of the legal forms – the different taxes on profit were discussed.
Income tax is applicable for natural persons and corporate tax for legal entities. In this paragraph, value added tax (VAT) will be discussed, which every company in Europe and most other countries have to deal with, regardless of their legal form. Value added tax is a tax raised on consumptive expenditures, which means that the end user of a product or service pays the tax.
To achieve this, a tax system on added value has been implemented. Every time a company makes a sale, it pays value added tax. Every country in the EU applies different rates. The basic rules imposed by the EU are:
- For delivery of products and services, the standard rate should be at least 15%.
- For a limited number of specified products and services, member states can apply one or two reduced rates of minimum 5%.

In the Netherlands, the standard rate for value added tax is 21%. The rate is added to the selling price of a product or service. The company will transfer the tax to its customer by increasing the selling price by the amount of tax due. The tax is due regardless of whether the delivery is to an end consumer or to another entrepreneur. If the buyer is an entrepreneur, he is entitled to reclaim the VAT charged to him from the tax authorities. If the buyer is an end consumer, he cannot reclaim the tax. The tax 'sticks' to his purchase.

EXAMPLE 1.8

A manufacturer of household appliances produces an air-fryer at a cost of €100. He sells the air-fryers to a wholesaler for €150. The wholesaler sells them to a retailer for €170 and the retailer resells the article to the end consumer for €200.

If the manufacturer sells one air-fryer to the wholesaler, he pays 21% of €150 = €31.50 value added tax. He will charge this to the wholesaler, who will receive the following bill:

Delivery of 1 air-fryer	€ 150
21% VAT	€ 31.50
	€ 181.50

The wholesaler sells the air-fryer for €170 to the retailer; he pays 21% of €170 = €35.70 value added tax. He will bill the retailer as follows:

Delivery of 1 air-fryer	€ 170
21% VAT	€ 35.70
	€ 205.70

The wholesaler pays €35.70 to the tax authorities but can reclaim the €31.50 value added tax he paid to the manufacturer. As a result he will pay €4.20, which is equal to 21% of the added value of €20 (€170 selling price – €150 purchase price).

The retailer sells the air-fryer for €200 to the consumer, who will pay 21% of €200 = €42 value added tax. He will bill the consumer as follows:

Delivery of 1 air-fryer	€ 200
21% VAT	€ 42
	€ 242

The retailer pays €42 to the tax authorities, but he can reclaim €35.70, which was charged to him. As a result he will pay €6.30, which is equal to 21% of the added value of €30 (€200 selling price – €170 purchase price).

The calculations of the sales process are summarized in a table.

Tax consequences for the entrepreneurs in example 1.8

		Price incl. VAT	VAT to pay	VAT to receive	Net price	Profit
Manufacturer	Cost	€ 100			€ 100	
						€ 50
	Selling price	€ 181.50	€ 31.50		€ 150	
Wholesaler	Purchase price	€ 181.50		€ 31.50	€ 150	
						€ 20
	Selling price	€ 205.70	€ 35.70		€ 170	
Retailer	Purchase price	€ 205.70		€ 35.70	€ 170	
						€ 30
	Selling price	€ 242	€ 42		€ 200	
Consumer	Purchase price	€ 242			€ 242	

Based on the table of example 1.8 the following can be concluded:

- Value added tax is not a cost to the company: the value added tax due, is charged to the customer and the value added tax paid to a supplier, is reclaimed from the tax authorities.
- Value added tax is not considered for the income statement (see chapter 3). Both sales and costs are presented without VAT.
- On average, value added tax is settled with the tax authorities once every three months. The balance between value added tax amount due and reclaimable is paid to the tax authorities (or is received from the tax authorities if the amount reclaimable exceeds the amount due).
- The consumer eventually bears the value added tax. In the given example he will be charged €42, which he cannot reclaim. For him, value added tax is a *cost-increasing tax*.

Cost-increasing tax

TEST QUESTION 1.6

Under what circumstances will the company receive the balance of the value added tax from the tax authorities?

Special circumstances for value added tax

- *Reduced rate*

A reduced rate (6% in the Netherlands) is applicable to some products and services. This includes among others, food.

- *Exemptions*

Certain products and services are exempt from value added tax. This concerns for example, services rendered by banks and insurances, medical services, agricultural supplies and supplies or services concerning real estate. An exemption has two consequences:

1. The entrepreneur is not liable for value added tax on the product or service.
2. The entrepreneur cannot reclaim value added tax paid by him to suppliers.

In fact, the company that is exempted from value added tax holds the same position as a private person.

EXAMPLE 1.9

Living LLC rents apartments to private persons. A customer is charged €500 for the rent in April. Living LLC receives a bill of €1,500 plus €315 VAT from a roofing company for roof repairs to one of its apartment buildings.

The company is not liable for value added tax on the rental revenue and therefore cannot charge the value added tax to the tenants.
The amount of €315 which is included in the bill cannot be reclaimed by Living LLC.

- *Export*

Value added tax is intended for consumptive expenditures within a particular country. Products sold from the Netherlands to other countries are not liable for value added tax in the Netherlands. These products will be liable for value added tax in the country of destination (if this tax exists in the country concerned). The products will cross the border 'free of tax'; this is achieved by applying a *zero rate*

Zero rate

EXAMPLE 1.10

Dutch Trading LLC buys wooden furniture from Dutch manufacturers and exports them to the United States. It receives a bill from a Dutch furniture manufacturer for the amount of €10,000 plus €2,100 VAT. An American buyer receives a bill for €15,000.

Dutch Trading LLC can reclaim the €2,100 value added tax it paid. The delivery to the United States is not affected by the Dutch value added tax. The United States will have to charge tax on the imported furniture.

A Dutch company that imports products from abroad, is liable for Dutch value added tax. It can reclaim this value added tax when the imported products are used for taxable services.

1.6 Types of cooperation between companies

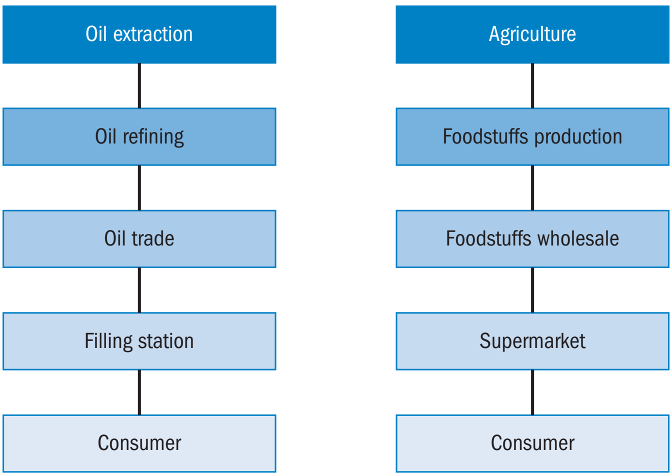
Companies can cooperate in varying degrees. In doing so they abandon their independence partly or entirely. What was formerly a competitor, has now become a colleague. Three forms of cooperation will be further discussed: merger and takeover, franchising and cartels.

Merger and takeover

If a company wishes to 'grow, it could start new activities. However, it is often easier to take over an entire company rather than pursue autonomous growth. Takeovers are normally achieved by one company buying shares of another. A merger is a situation where there is not one company taking over the other, but two equal parties merging together.
The relationship between the acquirer and acquiree can be very different; this will be explained with the aid of terminology derived from the industry and supply chain. A supply chain is a total chain of all companies involved in the production of a product or service. It concerns all stages of the combined process that a product follows from producer to consumer. Companies operating at one level of the supply chain form an industry.

In figure 1.5 two supply chains are shown.

FIGURE 1.5 Supply chains



A distinction between the following types of takeovers (and mergers) can be made:

1 Acquirer and acquiree operate in the same industry. If a chain of gas stations takes over another chain of gas stations, this can offer the advantages of less competition and cost reduction, for example due to economies of scale.
2 Acquirer and acquiree operate at consecutive levels of the supply chain. For example, if an oil extracting company takes over an oil refinery. This is called *vertical integration*. Vertical integration is common practice in

Vertical integration

the oil industry, for example Royal Dutch Shell controls the entire supply chain both up and downstream.

3 Acquirer and acquiree operate at the same level of different supply chains. An example of this is the oil wholesaler taking over another wholesaler, for example in food (to supply stores at gas stations). Such a takeover is an example of *horizontal integration*, widening of the assortment.

Horizontal integration

4 Acquirer and acquiree operate at different levels and in different supply chains. In the past, many conglomerates were created: business groups active in various levels of various supply chains. The idea behind this was that it is an effective way to spread risk. Nowadays, these *conglomerates* are no longer popular, as such a mix of different companies proved to be very difficult to control by a centralized management. In the past few years, a trend towards 'back to core business' has been observed: companies focus on their core business and sell off other parts of the company.

Conglomerates

Franchising

The formula where a single entrepreneur joins a chain and uses certain facilities offered by that chain, such as purchasing, marketing and store layout, is known as *franchising*.
For the franchiser it is important that the entrepreneur is familiar with the local market. The franchisee runs the company as if he was an independent entrepreneur but profiles his business activity as part of a large chain, assisting and managing the entrepreneur. The franchisee pays a fee to the franchiser. Franchising is common practice nowadays, both in retail trade and services.

Cartels

Cartels are agreements between manufacturers and are designed to restrict competition. The opportunity to draw up such agreements depends on the market in which the companies operate.

Competitive market

Monopoly

In a *competitive market* there are many companies offering a standardized product to many customers. This results in harsh competition. The other extreme is the *monopoly*: only one provider and therefore no competition. Cartels will not exist under either of these circumstances.

Oligopoly

An *oligopoly* is a market with relatively few providers. Road construction is a good example.

TEST QUESTION 1.7

Name two other examples of industries that operate in an oligopoly market.

In an oligopoly, companies can easily be tempted to collude and make price agreements with one another. They could even divide the market between them. In such an event there is a cartel situation. Due to the potentially damaging effects for consumers, fighting cartels is high on the priority list of the European Union. Cartel agreements are illegal under European Competition Law and the European Commission heavily fines companies that participate in such agreements. As cartel agreements are illegal, they are made secretively and it is difficult to prove their existence. In the Leniency Notice, companies are encouraged to provide inside information

on cartel agreements to the European Commission. The participant of a cartel agreement who informs the European Commission first, is cleared of a fine. In the Netherlands the Authority for Consumers and Markets (ACM) plays an important role in fighting cartel agreements, and imposes heavy fines on companies that enter into (price) agreements.
The issues concerning markets and competitive relations is part of general economics, but of course has important consequences for business economics.

The European market for North Sea shrimp, also known as the common shrimp, is dominated by Dutch shrimp traders. In this market there are a limited number of providers. The Heiploeg Group, with their main office in Zoutkamp, is the leading shrimp supplier in Europe and allegedly the number one in the business. Heiploeg supplies approximately 5 million kg end product per year.
End 2013 it became public knowledge that the four major shrimp suppliers had formed a cartel, which had been in existence for at least nine years. The companies agreed prices and divided between them the sales volumes in the Netherlands, Belgium, Germany and France. The European Commission fined the four traders a total amount of €28.7 million. One of the four, Klaas Puul, was exempt from paying a fine based on the Leniency Notice because he revealed the cartel agreement.
In 2003 the Dutch cartel watchdog NMa (now ACM), already stated that there were illegal price agreements and quota restrictions. At the time, the NMa fined the branch a total of approximately €6 million.

Glossary

Business economics	Discipline in economics that studies economic behavior in companies.
Capital	The production factor consisting of raw material and tangible assets of a company.
Cartel	Companies that collude to limit competition. An agreement between these companies is called a cartel agreement.
Company	Production organization striving for profit.
Cooperative	Association performing business activities on behalf of its members.
Economics	Science that studies human behavior with respect to the striving for wealth, being the optimal provision of goods and services.
Effectiveness	Focus of the production process on the production of goods and services that will be in demand by customers.
Efficiency	Expedience of a production process to produce a certain amount at minimal cost.
Franchising	Formula in which an entrepreneur, on payment of a fee, joins a chain to be able to use certain facilities offered by the chain.
General partner	Partner in a limited partnership who is both manager and partner.
Horizontal integration	A company adds activities from the same level of a different production chain, and therefore different production process, to its business activities.
Industry	The combined companies in a supply chain.
Job production	Production method for producing a product adapted to the specific needs of a customer.
Legal entity	Independent body with its own equity, rights and obligations.

Limited liability company	Company with a legal entity status and freely transferable shares, divided capital equity.
Limited partner	Partner in a limited partnership, owner but not managing the business.
Limited partnership	Cooperation between two or more natural persons in which one or more persons functions as a money supplier.
Mass production	Production method for producing one type of product in large quantities.
Merger	The joining of two previously separate companies into one.
Mission statement	Summary of the organization's objectives.
Organization	Cooperation between people and resources, with the aim to achieve a particular objective.
Partnership	Cooperation between two or more natural persons to perform business activities under a joint name.
Production	The creation of goods and services to provide human needs.
Public limited company	Company with a legal entity status and usually freely transferable shares, divided capital equity.
Sole proprietorship	Company run by one person, who is manager and owner.
Substantial business interest holder	Taxable person who owns at least a 5% share capital of an LLC or a PLC, will be taxed in box 2.
Supply chain	A chain of companies that succeeds one after another in the production process.
Value added tax	Tax paid by entrepreneurs on the sale revenues is charged to the buyer. Entrepreneurs can reclaim the tax they paid.
Vertical integration	A company adds a production level of the supply chain to its business activities, previously performed by a different company.

Multiple-choice questions

1.1 Which of the following organizations is *not a* company?
- **a** A CD-store.
- **b** A university medical center.
- **c** A shipping company.
- **d** A tax consultancy.

1.2 Which of the following activities is *not* in the field of efficiency?
- **a** Bundling purchases and dealing with a limited number of suppliers to achieve larger discounts.
- **b** Modifying a product to shorten production process time.
- **c** Sending invoices faster.
- **d** Modifying a product to tailor it to customers' requirements.

1.3 Which of the following statements is correct?
- **a** Changing the nature of their activities is more difficult for companies than non-profit organizations.
- **b** Non-profit organizations are economically independent because they receive "free gifts".
- **c** Offering discounts to regular customers corresponds with the view of striving for maximum profit.
- **d** Companies act according to budget mechanism rather than market mechanism.

1.4 Which of the following statements is *not* correct?
- **a** Assessment of effectiveness is more difficult in companies than in non-profit enterprises.
- **b** Non-profit enterprises can also strive to work as efficiently as possible.
- **c** Public goods and services are produced by the government because the market mechanism fails for those goods and services.
- **d** A negative financial result does not necessarily imply that a non-profit enterprise performs poorly.

1.5 Which of the following statements is *not* correct?
- **a** A service company purchases hardly any raw materials.
- **b** Mass production focuses on production to build-up inventory, not to order.
- **c** One of the transformation functions of trading is time.
- **d** For service companies, personnel costs are usually an insignificant part of the total cost.

1.6 A car is produced with two different engine types. What type of production is this?
- **a** Job production.
- **b** Batch-job production.
- **c** Batch-mass production.
- **d** Mass production.

1.7 Which of the following statements is correct?
Statement 1: Wholesale is a 'business-to-business'-market.
Statement 2: Wholesalers trading in seasonal products play an important role in bridging the time gap between production and consumption.
a Both statements are correct.
b Statement 1 is correct, statement 2 is wrong.
c Statement 1 is wrong, statement 2 is correct.
d Both statements are wrong.

1.8 Which of the following company forms has *no* financial disclosure requirements?
a Partnership.
b Limited Public Company.
c Limited Liability Company.
d Cooperative.

1.9 Which of the following statements is correct?
Statement 1: Increasing the number of partners in a partnership will offer creditors more options for debt recovery if the partnership should fail to pay its debts.
Statement 2: A limited partner holds a more favorable position than his managing partner when it concerns liability.
a Both statements are correct.
b Statement 1 is correct, statement 2 is wrong.
c Statement 1 is wrong, statement 2 is correct.
d Both statements are wrong.

1.10 The limited partnership ABC has two general partners and one limited partner. General partner A has invested €100,000, partner B €50,000 and limited partner C €450,000. The partnership has a total debt of €1 million. For which amount is partner A liable?
a €100,000
b €500,000
c €550,000
d €1,000,000

1.11 A retailer buys 1,000 radios in one quarter, costing €20 each. He sells 700 radios in the Netherlands for €30 each and exports 300 radios to Belgium for €40 each. All prices are exclusive VAT. The value added tax rate is 21%. How much value added tax will the retailer have to pay to the tax authorities for that quarter?
a €210
b €1,470
c €2,730
d €4,410

1.12 What does a supply chain comprise?
a A number of companies performing the same production process.
b A number of companies following one after another in the production process from raw material to end product.
c All companies operating in a particular industry.
d Competing companies that produce the same product.

1.13 A wholesaler takes over a retailer. What is this called?
- **a** Conglomerate.
- **b** Vertical integration.
- **c** Horizontal integration.
- **d** Merger.

1.14 For what purpose do companies form a cartel?
- **a** To share the risk of setting up a new company.
- **b** To buy out competitors through takeover.
- **c** To be stronger in their mutual negotiations with the unions.
- **d** To limit mutual competition.

1.15 In which market(s) can cartels easily occur?
- **a** Monopoly.
- **b** Oligopoly.
- **c** Competitive market.
- **d** All named markets.