The Basics of Financial Management

Answers and Solutions

Noordhoff

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Olaf Leppink MSc

3rd edition

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Preface

In *Answers and Solutions*, the answers to all the questions in the exercise book are provided. It is recommended to first solve these questions without any help, and to check the answers by using this answer book.

To make sure that you have mastered the subject matter, it is necessary to independently answer the knowledge questions (marked K) and exercise questions (marked E) for each paragraph covered in the theory book and check the answer. For a thorough understanding of the subject of financial management, the answers to the insight questions (marked with I in the exercise book), in which a connection is made between different parts of the subject matter, are included.

With the revision of the exercises book to accompany *The Basics of Financial Management*, the *Answers and Solutions* have also been revised. This third edition is in line with the fourth edition of the exercises book.

Answers and Solutions intends to facilitate the student's active approach. During lectures there is often (too) little opportunity to discuss a sufficient number of exercises. With the assistance of the *Answers and Solutions* book, the student can independently work on exercises and receive feedback on the accuracy of the calculations.

In this edition, a summary of each chapter of *The Basics of Financial Management* is included. Additional practice material with Excel variations is also available on the website. These are indicated by an icon in both the exercise book and the answers and solutions book.

We hope that this instruction can contribute to a positive study result for financial management.

The authors

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Series Overview

The Basics of Financial Management
The Basics of Financial Management - Exercises
The Basics of Financial Management - Answers and solutions

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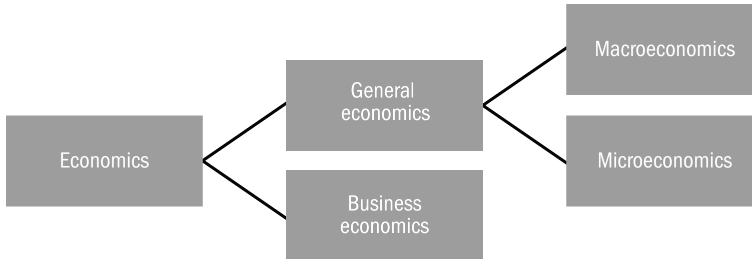
PART 1
Business Economics and Companies

Summary Chapter 1 Businesses and their Role in the Economy

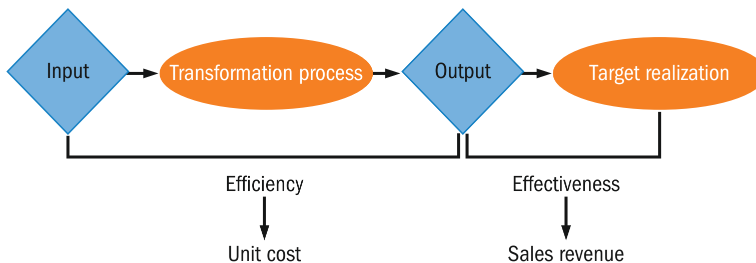
1 Economics and Business Economics

Economics deals with issues related to man's pursuit of prosperity: how can someone optimally provide goods and services, i.e., with the least possible sacrifice of resources. *Businesses* play an important role in the economy, producing goods and services and selling them to consumers at a certain price. Consumers have the necessary purchasing power through the income they earn in businesses. *Business economics* is the part of economics that focuses on the economic activity within businesses.



2 Characteristics of Companies

A *company* is a business that seeks to make a *profit* by producing goods and/or services and selling them to the consumer. Making profit, the difference between *revenues* and *costs,* is necessary to ensure the survival (continuity) of a company. In this pursuit of profit, the concepts of efficiency and effectiveness (purposefulness) of the production process play an important role. *Efficiency* refers to the cost-effectiveness of the production process, or achieving a goal with as few resources as possible. *Effectiveness* refers to the goal-orientation of the production process, or the extent to which the end product is suitable to meet the requirements.



Characteristic of a company is that the profit figure is a measure of both efficiency and effectiveness; it is, after all, the balance of sales revenue (measure of effectiveness) and costs (measure of efficiency).

3 Characteristics of Non-Profit Organizations

Because companies aim to make a profit, they belong to the *profit sector*. There are also businesses that do not aim to make a profit. These are

called *non-profit organizations*. A distinction can be made between public and private non-profit organizations.
The *public sector* consists of national, state/provincial and local governments. The government primarily provides public services, such as zoning, fire brigade, and education. The *private non-profit sector* consists of a wide variety of organizations. Examples include all kinds of associations and charitable organizations.
Organizations in the non-profit sector differ from companies in the following respects:

- Non-profit organizations aim to provide certain (socially important) services. The activities they perform are directly related to that objective. Switching to other activities for financial and economic reasons is out of the question. For a company, switching to another activity if that promises higher profits is not a problem.
- Non-profit organizations cannot normally survive by conducting business market transactions and are – unlike companies – not economically independent. They depend on contributions, grants, donations, inheritances and the like.
- Assessing effectiveness is much more difficult with non-profit organizations than with companies. In the latter case, the profit figure indicates the degree to which both efficient and effective production has taken place. Such a profit figure cannot be used in the non-profit sector.

4 Business Activities

The activities carried out by companies can be divided into:

- Agriculture, forestry, fishing and mining (primary sector)
- Manufacturing (secondary sector)
- Trade (tertiary sector)
- Services (quaternary sector).

The specific nature of these activities for each sector determines the resources for the company and the investments that need to be made.

Typical for the *primary sector* is that hardly any raw materials are used; nature is the source of production.
In *manufacturing companies*, a distinction can be made between job production and mass production. This distinction is based on the question of the extent to which the specific wishes of the customer are considered in production.

TABLE 1 Differences between job and mass 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

Batch-job production and batch-mass production are intermediate forms that make use of the production of series of identical (half)products.

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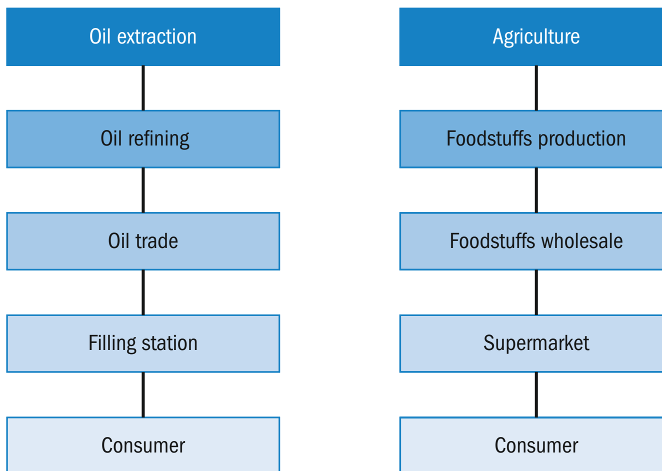
The *trade sector* handles the distribution of products: goods are purchased from suppliers and sold to buyers. Trading companies can be divided into wholesale (sales to other companies) and retail (sales to consumers). Trading companies derive their raison d'être from the fact that there is no equality between production and consumption. This inequality can relate 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.

Service companies do not involve concrete movement of goods, the service is the product that is provided. The service sector includes companies of very different nature such as financial services (banks, insurance companies, etc.), hospitality industry, IT services (software agencies, computer advice agencies), facility services (security, catering, cleaning).

5 Supply Chain and Industry
There is a 'division of labor' among the many companies: one company could be in the textile industry, another in the construction industry, and a third as part of the business services industry, for example. Generally speaking, an individual company is only one link in the total process that a product goes through before it reaches the consumer. This sequence from initial producer to final supplier to the consumer is called *supply chain*.



Companies that belong to the same link of a supply chain, or perform the same production process, are called an *industry.* Large companies can operate in different supply chains and industries. When a company takes care of successive links in a supply chain, it is called *vertical integration.* It is also possible that a company operates in a similar link in different supply chains to broaden the product range. This is called *horizontal integration*. Some companies have become so large that they operate in different links of different supply chains. This is called a *conglomerate.*

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6 Types of Cooperation between Companies

There can be all kinds of collaborations between companies. If a company wants to grow, it may choose to take over another company. A *takeover* is normally achieved by a company buying the shares of another company. The term *merger* is used in the situation where there is no acquiring party or an acquired party, but of two equal parties merging.

A *joint venture* is a partnership between two businesses, in which they set up a new business together. The participating businesses jointly own the joint venture and share both profits and any losses. In this process, the participating businesses continue to exist independently.

A very common form of cooperation in both the manufacturing and service industries is *franchising*. Franchising is a close-knit form of cooperation between legally independent entrepreneurs, the franchisor and the franchisee, who offer products and services to customers using a common name and with a uniform appearance. In franchising, an independent entrepreneur joins a chain using certain facilities, such as purchasing, marketing and store layout.

In *cartelization*, independent producers make agreements that limit free competition. An *oligopoly* involves a relatively small number of suppliers. In this situation, the companies may be tempted to make agreements fairly quickly with each other about the selling prices. They may even decide to divide the market between themselves, this is called a cartel. Because of the potential harm to consumers, cartels are prohibited under EU competition rules.

Summary Chapter 2 Companies

1 Legal Forms of Companies

Every company has a *legal form.* The choice of legal form determines how the legal relationships within the company and between the company and the outside world are structured. Companies can be divided into two major categories: companies with a *legal entity* and companies without. If the company is operating as a legal entity, it is considered a party in the legal agreements that involve doing business.
We distinguish the following company forms:
- Without legal entities: sole proprietorship, partnership, limited partnership or professional partnership
- Legal entities: corporation, limited liability company or a cooperative.

For non-profit organizations, the foundation and the association are relevant legal forms. Foundations and associations have legal entities.

2 Sole Proprietorship

The main characteristic of the sole proprietorship is that the management and ownership of the company rests with one person. The qualities as well as the health of this person determine the success of the company. In the long term, the *continuity* of the company is uncertain. A sole proprietorship all depends on the person running it.
The *equity* of the sole proprietorship comes from the private assets of the owner. The size of a sole proprietorship will therefore normally be limited.

The entrepreneur pays *income tax* on the profits made with the sole proprietorship. The entrepreneur is legally obliged to keep records, but has no obligation to publish the financial position of the company.

3 Partnerships

A *partnership* is a collaboration between two or more persons. These partners jointly own the company. The partnership's equity comes from the private capital of the partners and is therefore limited. In a partnership, the partners are *jointly and severally liable* for the debts of the company. For tax purposes, the partnership does not exist. Each partner is deemed to run a separate business (for their share of the profits). Income tax is levied on this profit share. The partnership has no obligation to publish its financial data.
The limited partnership is a collaboration between persons, where at least one partner is not involved in the management of the company. The liability of this partner is limited to the capital contributed by him. In all other respects, the limited partnership is similar to a partnership.
The *professional partnership* is a form of cooperation between persons practicing the same profession. These partners are each liable for a portion of the debts. In all other respects, the professional partnership is similar to a partnership.

4 Joint-stock Companies

A joint-stock company can take the form of a *limited liability company* (LLC) or a *corporation*. LLCs and corporations are both legal entities and there is a separation between the ownership and the management of the company. The ownership rests with the *shareholders* who have collectively accumulated the equity of the company. The management rests with an appointed *board of directors*, who are employees of the company. The rules for the management of an LLC and corporation are known as the Corporate Governance Code. The profit of LLCs and corporations is subject to *corporate tax*. Due to the separation between management and ownership, continuity is better guaranteed for LLCs and corporations than for companies without legal entity. The shareholders have *limited liability* for the debts of the company. They can lose a maximum of their contribution. LLCs and corporations are subject to *disclosure requirements*, which means that they must publish their financial figures.

The main differences between LLCs and corporations are:

1. LLCs only have *registered shares*, whereas corporations also have the possibility of issuing *bearer shares* which can easily change owners. That is why listed companies are always corporations.
2. The articles of association of an LLC may include a buy-out agreement, which imposes restrictions on the shareholder when selling their shares.
3. In the Netherlands a minimum initial capital of €45,000 is required to establish a corporation. There is no required minimum capital for an LLC.

5 Cooperative

A *cooperative* promotes the common interests of its members. A cooperative has legal entity. The cooperative's equity has been accumulated by its members. The management rests with an appointed executive board.

The continuity of the cooperative is guaranteed by the fact that it may be stipulated that members may not leave the cooperative overnight. Moreover, members may be required to conduct all their business with the cooperative.
The liability of the members of a cooperative may be regulated in different ways:
1 Legal liability: members are liable for the debts of the cooperative.
2 Excluded liability: members cannot be required to pay the debts of the cooperative.
3 Limited liability: members are liable for the cooperative's debts up to a certain maximum amount per member.

The cooperative's profits are subject to corporate tax. When profit is distributed to the members, it is subject to income tax in box 1. There are disclosure requirements for the cooperative.

6 Association and Foundation

For non-profit organizations, there are two legal forms that are not aimed at making a profit: the association and the foundation.
An *association* is a collection of people organized for a specific purpose. The law grants legal entity to all associations, but at the same time makes a distinction between full and limited legal capacity:
- Associations with *full legal capacity* have had their bylaws recorded in a notarial deed.
- Associations with *limited legal capacity* are the other associations.

A limited liability association is limited in its rights in two respects:
- The association cannot acquire registered property in its own right, nor can it be an heir. It may, however, accept bequests.
- The board members are personally liable for debts apart from the association.

An association is formed by its members. These can be natural persons (people) or legal entities (companies). The members usually pay a membership fee. Members have influence on the policy of the association through the general assembly of members. The daily management is in the hands of an elected *board.*

A *foundation* aims to achieve a particular social, societal or idealistic goal. A foundation has a *board.* The board of a foundation may be employed by the foundation. Usually, the board members are only reimbursed for expenses incurred. A foundation can own a company. The profit of the company must then be spent on the purpose of the foundation. A foundation is a legal entity. This means that the board members are not liable for debts. A foundation that operates a company pays corporate tax on the profits of the company.

7 Income Tax for Entrepreneurs

An entrepreneur, owner of a sole proprietorship or partner in a partnership, pays *income tax* on profits made in the company. Income tax in the Netherlands consists of three different taxes (boxes). Labor income is taxed in *box 1*, which has an increasing sliding scale. *Box 2* concerns taxable income from

substantial interests and *box 3* concerns taxable income from savings and investments. Because the company profit of a sole proprietorship or partnership is considered labor income for the entrepreneur, the company profit is taxed in box 1. Entrepreneurs are entitled to various tax facilities:
- *entrepreneurial tax relief*, which consists of private business ownership allowance and new companies tax relief
- *SME profit exemption*.

Every taxpayer liable for income tax is also entitled to the *general tax credit* and the *labor tax credit*.
Schematically, the calculation of the tax amount to be paid is as follows for an entrepreneur:

	Incurred profit	
–	Entrepreneurial tax relief	
	Profit after entrepreneurial tax relief	
–	Profit exemption	(14% of profit after entrepreneurial tax relief)
	Taxable profit	
	× Rate	
	Taxes	
–	Tax credits	
	Payable taxes	

8 Profit Tax in Legal Entity Companies

A company that is a legal entity pays *corporate* tax on the profits it makes. Each country uses its own system with respect to corporate tax. The two main systems are the classical system and the imputation system. Under the *classical system*, the company pays corporate tax on company profits and the shareholder pays income tax on dividend. Under this system, profit distributed as dividends is taxed twice.

Under the *imputation system*, the corporate tax paid by the company is considered an advance tax on behalf of the shareholder. The shareholder pays income tax on their share of the company's profit and may deduct the corporate tax paid on their behalf from the amount payable. The Netherlands applies the classical system. Corporate tax has a low rate (in 2020 16.5% for the part of the taxable amount up to and including €200,000) and a higher rate (in 2020 25% above €200,000).
For tax purposes, it is possible to offset a loss in one year against profits in another year to reduce the payable taxes: the so-called *loss offset*.

The owners of the company (shareholders at an LLC or a corporation) pay income tax on the distributed profits. A shareholder who owns at least 5% of the share capital (substantial business interest holder) is taxed in box 2 of the income tax. A shareholder who holds less than 5% of the company's shares is taxed in box 3 of the income tax.

9 Value Added Tax

Every company has to deal with *value added tax* (VAT). A company that makes a sale owes value added tax on the proceeds of the sale. It will pass this tax on to the customer. If the buyer is a business owner, it can reclaim

the value added tax charged from the tax authorities. The consumer 'bears' the value added tax because they cannot reclaim the tax charged to them. Value added tax has a standard rate and a low rate.

There are also services that are exempt from value added tax. These include, for example, banking and insurance services, medical services, education, and real estate deliveries.

An exemption has two consequences:
1 The company does not owe any value added tax on the delivery or service in question.
2 The company cannot reclaim the value added tax passed on to them by suppliers.

Value added tax is not due in the Netherlands on goods sold from the Netherlands to foreign countries, but it is due in the destination country.

Summary Chapter 3 Business Economics: Disciplines and Positions

1 Business Economics: Disciplines
Business economics is divided into three parts:
1 *Finance* deals with the investments to be made by the company and how best to finance those investments.
2 *Management accounting* concerns the (financial) reporting to management, so that they can make responsible decisions.
3 *Financial accounting* deals with external financial reporting to shareholders, employees, lenders, financial press and other stakeholders. In particular, the annual report is used for this purpose.

Investing and financing are two sides of the same coin. A company invests in assets to create added value. The value of the goods or services produced with the assets will have to exceed the amount of investment. Usually, there are several alternatives to a proposed investment; in that case, *selection criteria* are needed to assess which alternative is best for the company. Once a choice has been made regarding the investments, the matching financing must be sought.

There are two important differences between management accounting and financial accounting. Firstly, there are *legal rules* for financial accounting, which prescribe which information the company must disclose. This is not the case for management accounting. Secondly, in the case of financial accounting, the fact that the company management may not reflect the real financial position to the outside world, 'coloring' the profit figure by means of *'creative accounting'*, should be taken into account. In the case of management accounting, company management wants to know the real situation, so there is no reason to present things better than they really are. Below an overview of the differences between management accounting and financial accounting:

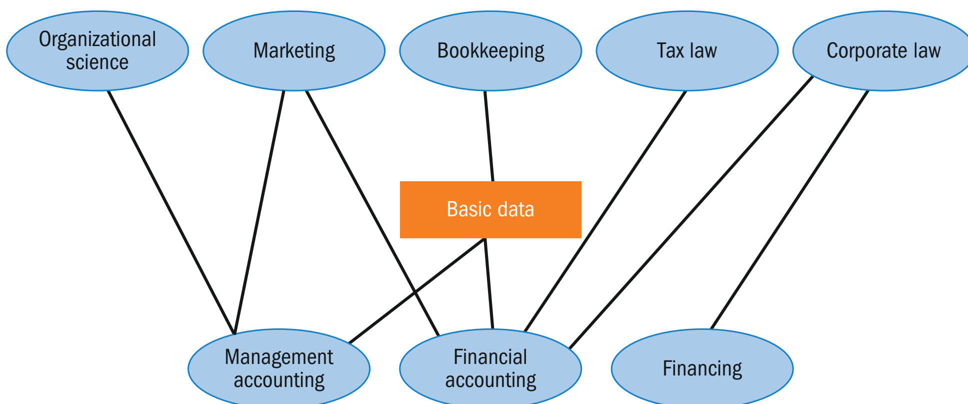
TABLE 1 The differences between management accounting and financial accounting

	Management accounting	Financial accounting
Target group	Management	Other stakeholders
Objective	Decision-supporting	Accountability
Focus on	Future	Past
Regulations	No	Yes
Inclination to creative accounting	No	Yes
Nature of information	Detailed	Aggregated
Priority	High	Low

2 Relationships to Other Disciplines

Disciplines related to business economics are:

- *Bookkeeping*
  This discipline deals with the recording of primary (especially financial) data, based on which management accounting and financial accounting can continue their work.
- *Company law*
  This is important for the rights and obligations, the financing possibilities of a company, and the legal rules for financial accounting (disclosure requirements), depending on the legal form.
- *Tax law*
  This concerns the tax rules relating to the payable tax on profits and sales tax.
- *Organizational behavior*
  This is about setting up an effective and efficient organizational structure in the company.
- *Marketing*
  The company's marketing policy is crucial to its success. The marketing efforts must ensure that customers buy the products and services.



3 Positions in Financial Management

An important position in the field of finance is the *treasurer*, who is concerned with the optimization of cash flows in the company. The *controller*

is central to management accounting, ensuring a well-functioning budgeting system for example. The *accountant* focuses on financial accounting. The *internal auditor* is concerned with checking the accuracy of recording financial facts within the company, the *external accountant* works at an accounting firm and conducts the annual audit required by law for a particular company.

The below table provides a characterization of the positions listed by discipline (the more asterisks, the more important the discipline in question).

TABLE 2 Positions and disciplines

	Bookkeeping	Finance	Management accounting	Financial accounting
Bookkeeper	***			
Internal auditor	**			**
Controller	*	*	***	*
Treasurer		***		

Summary Chapter 4 Financial Statements

1 Investment and Financing

A *balance sheet* shows the investments that a company has made (debit side) and how those investments have been financed (credit side).
The investments are called *assets* and can be divided into *fixed assets* (providing their services to the company for more than one year) and *current assets* (providing their services to the company for up to one year).
As far as the method of financing is concerned, a distinction can be made between equity and liabilities. *Equity* is made available to the company by the owners for an indefinite period of time. The remuneration they receive for making it available is the profit. Equity is *risk-bearing capital* because the remuneration is not fixed and, moreover, in the event of bankruptcy, the equity providers are the last to be repaid their deposits.
Liabilities are made available by creditors for a certain period of time. Their remuneration is interest. Since this is fixed in advance and, moreover, in the event of bankruptcy the providers of the liabilities are the first to be reimbursed, liabilities are referred to as *risk-avoiding capital*.

TABLE 1 Differences between equity and liabilities

	Equity	Liabilities
Provided by	Owners	Creditors
Duration of availability	Indefinite period	Temporary
Compensation	Depends on profit	Usually fixed
By nature	Risk-bearing	Risk-avoiding

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2 Balance Sheet and Income Statement

The *balance sheet* is an overview of, on the one hand, the assets in which the company has invested and, on the other hand, how these investments have been financed (capital). There are two forms of presentation for the balance sheet:

- the T form, in which the investments are listed on the left-hand side (the debit side) and the financing on the right-hand side (the credit side);
- the vertical form, in which the assets and financing are placed below each other.

Since every euro of investment must be financed in some way, a balance sheet is by definition balanced. A company's equity is equal to the difference between the value of its assets and the value of its liabilities. By comparing the equity at two different balance sheet moments, *profit* in the intervening period can be calculated. In principle, the increase in equity is profit; however, if in the interim, the owner(s) have brought amounts into the company (deposits) or taken amounts out of the company (withdrawals), a correction must be made. We can further analyse profits by looking at the sales revenue and costs incurred in the period in question. Such an overview of sales revenue and costs is called an *income statement*.

Sales revenue does not necessarily equal *cash-inflows.* Revenues from sales transactions are taken at the time the company has performed the relevant service, even if the customer has not yet paid. *Costs* are not necessarily equal to *cash-outflows*. Costs are recognized when use of assets occurs, regardless of whether payment is made at that time.

3 Profit versus Cash Flow

Profit, as shown on the balance sheet and income statement, need not be the same as the change in cash. Three factors that can create a difference between cash flow and profit are:

- depreciation
- provisions
- direct equity transactions.

Depreciation is a cost, not a cash-outflow. Fixed assets provide services to the business for several years. To give an accurate picture of the financial position, the investment expense incurred at the time of purchase should not be charged to the result at once, but spread over the life of the asset. The decrease in value of the asset as a result of its use is recorded as costs in the income statement as depreciation.

Provisions have to be recognized in the event of potential future obligations as a consequence of business activities in the past year. By creating provisions, costs are recognized on the income statement before an actual payment takes place. Costs are already included now, while (possible) cash-outflows will only be incurred in the future.
Since provisions are based on estimates, they provide a subjective element in the determination of profit. The cash flow is not subject to manipulation, but profits can be adjusted up or down due to overly optimistic or pessimistic estimates in determining provisions.

If equity is contributed to or withdrawn from the company by the owner(s) of the company, this does not affect profit. We call this *direct equity*

transactions. In a sole proprietorship or partnership, these are private deposits and private withdrawals from the company's equity. These have no influence on the profit because they are not caused by the business activities. In the case of a corporation or LLC, shareholder payments on the issue of new shares do not constitute profit in the same way, and profit distributions in the form of dividends do not belong to the costs.

4 Depreciation Methods

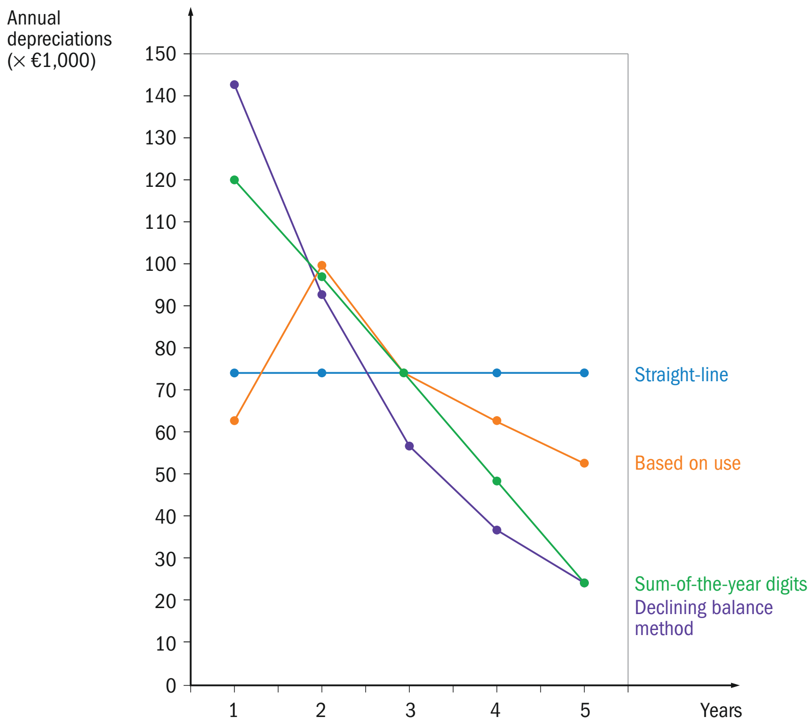
In order to determine the annual depreciation of a fixed asset, it is necessary to make an estimate of the economic life and of the residual value (if any), and to choose a depreciation method. Possible depreciation methods are:

- Straight-line depreciation; the same amount is depreciated each year
- Accelerated depreciation; more depreciation is applied in the early years than in the later years. This can be achieved by applying the sum-of-the-years-digits method or the declining balance method.

Under the sum-of-the-years-digits method, annual depreciation is determined by a decreasing weighting factor equal to the remaining economic life in years. In the declining balance method, a fixed percentage of the book value is depreciated. The book value is the value after deduction of depreciation in previous years. Typically, the percentage is set at twice the rate that would have been used for straight-line depreciation.

- Depreciation based on use.

The course of annual depreciation is compared with the different depreciation methods in the figure below.



Summary Chapter 5 Business Plan

1 Functions of a Business Plan

Every year, people take the step of starting a new business. The vast majority being self-employed (without personnel). After five years, only half of these businesses survive. Anyone starting a company therefore benefits from having a well thought out *business plan*.

For an entrepreneur, the plan acts as a checklist and a tool for mapping the feasibility of their company. For potential lenders, the plan can be a means of winning them over. Traditionally, starting entrepreneurs turn to family members or the bank for additional financing.

2 Key Parts of the Business Plan

A business plan must include the following:

- The *qualifications* of the starting entrepreneur: background, education, work experience.
- The *business idea.*
- Description of the market and the *marketing mix*. The marketing mix is the set of variables that determines the attractiveness of the company with respect to the customer. These variables are known as the four or five Ps that must be fulfilled by the company: product, price, promotion, place and possibly personnel.
- *Legal aspects:* the legal form and necessary permits.
- The *organizational structure,* including the division of tasks and responsibilities.
- *Financing:* Starting a business requires investment. Not only in fixed assets such as a building, equipment, car, but also in current assets (inventories and cash and possibly receivables from customers). These investments must be financed. Financiers can provide equity capital or loan capital.

Loan capital is less risky for the financier than equity capital, because a fixed interest rate is normally paid on loan capital and because if the company goes bankrupt, the loan capital providers are ‘first in line’ to be repaid. Only when they have received their money the equity providers come into play.
Banks are institutions that are pre-eminently specialized in lending money. The objective of *venture capital companies* is to participate in start-up companies; when the company has reached the stage of ‘maturity’, the venture capital company sells its shares again. Venture capital is often used in this context because there are obviously relatively high risks involved in financing start-ups. An *angel investor* is a former entrepreneur, who has money left over from the sale of the company they started several years before. An angel investor particularly invests in (pre)start-ups and entrepreneurs in an early growth phase of their business. In addition to money, an angel investor also brings knowledge and experience and makes their personal network available.

Starting companies are also often financed with subordinated loans; these are loans on which the interest and redemption are only paid when the obligations towards the other creditors have been fulfilled.

3 Financial Substantiation of the Business Plan

A business plan includes the financial elaboration of the plans. First, an overview must be given of the necessary investments in assets (*the investment plan*) and of the way in which the starter intends to finance these investments (the *financing plan*). A *financing gap* occurs when the amount that the starter can put into the business plus the commitments they already received from external financiers is not yet sufficient to cover the planned investments. Using the business plan as support, other financiers must then be 'won over'. The investment plan and financing plan together form the projected opening balance sheet of the company.

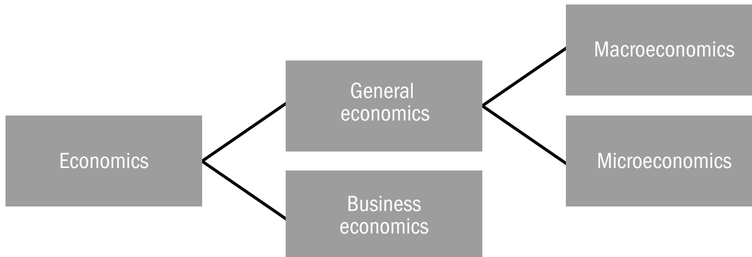
The next step is to draw up the forecast *income statement* for the first year of operation, possibly with a forecast of the profit figure for subsequent years. The starting point for this is the profit estimate included in the commercial section of the business plan. A *cashflow statement*, which maps out the expected cash-inflows and outflows, must also be included. Finally, a forecast of the balance sheet at the end of the first business year is given, based on data from the income statement and the cashflow statement.

1 Businesses and their Role in the Economy

Knowledge Questions

K1.1 Economics studies issues related to man's pursuit of prosperity: how can a person optimally provide goods and services, that is, with the least possible sacrifice of resources.

K1.2



K1.3 Business economics focuses on the economic actions within production organizations.

K1.4 A company is a production organization striving for profit.

K1.5 Effectiveness is the extent to which the desired objective is achieved, 'doing the right thing'. Efficiency is the extent to which resources are used to achieve the objective, 'doing things right'. Accordingly, effectiveness is about whether the objective is reached, and efficiency about the costs involved.

K1.6 The striving for profit will usually be focused on the long term, and a relationship of trust with customers is required to achieve this. It is possible to generate more profit in the short term, for example by misleading advertising, but this is avoided due to the focus on the long term. Furthermore, there are other objectives, such as attention to employment and the environment.

K1.7
- **a** Eneco is a company of which the majority of shares is held by Dutch municipalities.
- **b** The fire department is a non-profit organization and fully subsidized by the government.
- **c** The Dutch Railways is a company, and is a PLC with one single shareholder, the Dutch Government.
- **d** The University of Applied Sciences Inholland is a non-profit organization, mainly subsidized by the government.
- **e** The Red Cross is a non-profit organization, mainly financed by donations.

K1.8 Privatization is the process by which the ownership of businesses and services passes from the government to the private sector.

K1.9
- **a** The police: percentage of unresolved crimes.
- **b** Probation services: percentage of ex-convicts remaining 'on the straight and narrow'.
- **c** The Kidney Foundation: increase in percentage of cured kidney diseases.

K1.10 **a** Horecarama: wholesaler
b Philips: manufacturing
c Bijenkorf: retail trade

K1.11 **a** Car manufacturing: batch-mass production.
b Compost production: mass production.
c The painting of a family portrait on commission: batch-job production.

K1.12
1 Accounting firm
2 Jeweler
3 Supermarket
4 Tobacco wholesaler
5 Touring car company
6 Brick producer

K1.13 Supply chain is the total chain of companies involved in the production of a product or service, the set of stages that a product passes through on its way from the producer to the consumer. The collective companies in a link of a supply chain form an industry.

K1.14 **a** A garden center selling Christmas items: horizontal integration.
b Mobile phone provider taking over a competitor: expansion in the same industry.
c Mail order company making its own deliveries: vertical integration.

K1.15 Break-up of a conglomerate.

K1.16 From a legal point of view, the franchisee is an independent entrepreneur. They work for their own account and risk. From an economic point of view, the entrepreneur is also dependent on the franchiser (the chain), who sells the store concept and often determines the purchasing and marketing. This requires teamwork and is sometimes difficult for ambitious and self-opinionated entrepreneurs. The concept fails if the franchiser does not ensure the collective store concept sufficiently or if individual entrepreneurs decide to make changes on their own. The fee, which every entrepreneur pays, and the services delivered by the central organization, could also be a source of conflict.

K1.17 There is a monopoly in the grid operator's own supply area. Grid operators manage the electricity and/or gas infrastructure in a certain area and fall outside the liberalization of the energy market. Therefore, they do not have to compete. To prevent abuse of this monopoly situation, the tariffs of grid operators are capped. The maximum tariffs that grid operators are allowed to charge are set on behalf of the government by the Office of Energy Regulation, which is part of the Netherlands Authority for the Financial Markets (ACM).

K1.18 A conglomerate is *one* company that operates in different links of different supply chains. A joint venture is a partnership between two companies, in which they create a new business together.