The Basics of Financial Management

Noordhoff Uitgevers

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4th edition

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Preface to the Fourth Edition

The Basics of Financial Management offers a complete and accessible introduction to the subject.
It can be used by first-year students 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 which serves to acquaint students with the behavior and the most important associated underlying economic aspects of companies. Parts 2, 3 and 4 discuss the disciplines of finance, management accounting and financial accounting. These parts can be studied and reviewed in any order.

In the third edition, we opted for a seamless connection between *The Basics of Financial Management* and its Dutch version *Basisboek Bedrijfseconomie*. This fourth edition continues that approach. Both works approach the subject matter from an international perspective, and the English edition also discusses the institutional aspects (such as tax and corporate law) that are important in a Dutch context.

There has also been a number of changes since the previous edition.
The current edition includes explanations of new and modern financing concepts, such as *angel investors*, *crowdfunding*, *credit unions* and *staple financing*. The terminology used in the discussion of investment projects has been updated to match the current literature on the subject: *cash flows* have been replaced with *free cash flows*. The discussion of financing markets pays more attention to derivatives, and the problems and issues specific to futures have been omitted.
The revised regulations for the publication of annual accounts have been incorporated. The chapter on financial statements has been restructured; more attention is paid to *impairments*. In light of the decline in practical significance of the replacement value system (as used in the Netherlands), the notions of nominalism an substantialism as theoretical concepts are no longer discussed.
Naturally, all interludes, partial annual accounts and statistics have been updated.

The Basics of Financial Management incorporates various test questions and multiple-choice questions. 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. Several of these are fully explained in *Answers and Solution*; remaining answers can be found in the teacher

section of the website: www.basicsfinancialmanagement.noordhoff.nl.
The student section of the website also includes additional assignments, interactive practice questions, summaries, and online courses covering terms and concepts.

It has been eleven years since the publication of the first edition of *The Basics of Financial Management*; the enthusiastic appreciation with which later editions have continued to be met by both students and teachers alike has encouraged us to remain focused on continuing to improve on its usefulness and usability.
Remarks or comments from our readers are, as always, very welcome.

The authors

Contents

Introduction

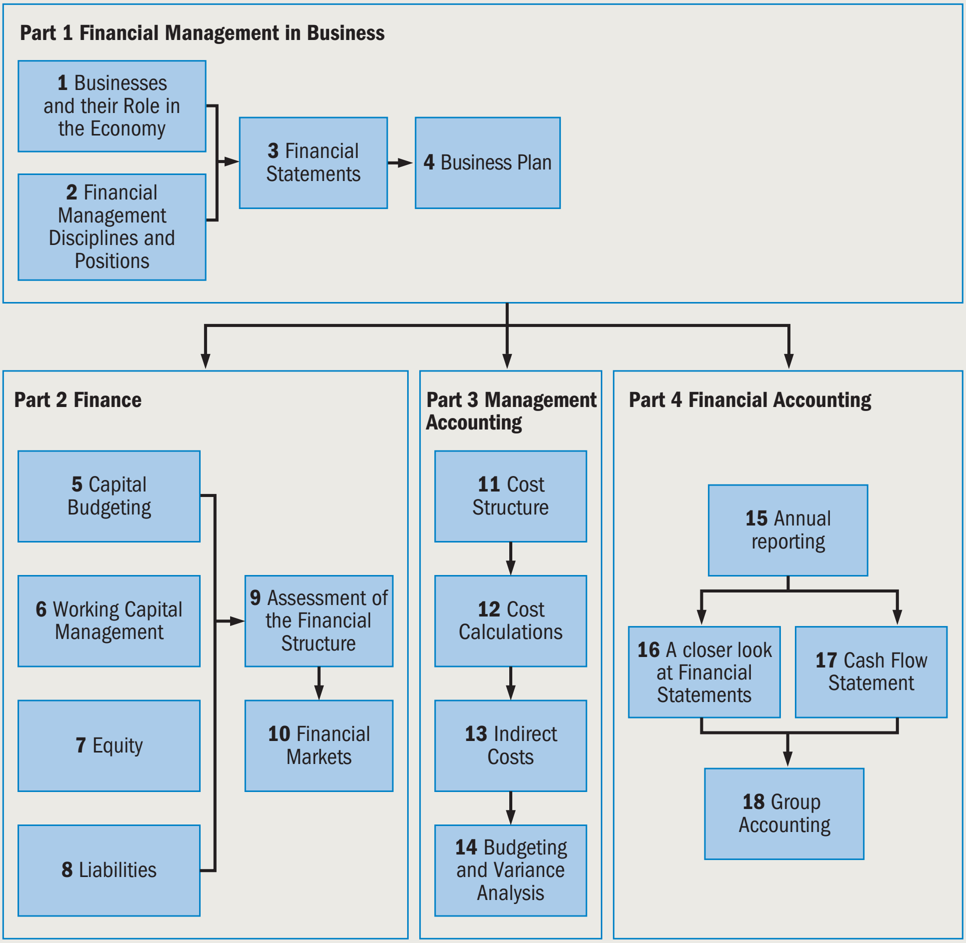
The Basics of Financial Management offers (future) professionals in a non-specific financial position an understanding of finance related issues that will allow them to act as fully-fledged interlocutors of financial specialists. In addition, the book offers basic training to prepare students in a financial-economic education for a more in-depth study of the subjects.

To maximize the usability of the book, a brief explanation on its possible uses is provided here.

The book comprises four parts: 1 *Financial management in business*, 2 *Finance*, 3 *Management accounting* and 4 *Financial accounting*. The first part provides an understanding of some of the basic concepts in business economics. Readers are recommended to start with this part. Armed with new-found or reinforced knowledge, the remaining three parts can be studied independently of one another.
To support students interested in studying one specific topic (for example, because they are enrolled in a problem-based or project-based education program), the introduction incorporates a schedule that shows the mutual relationships between the chapters of the book. This will allow students to verify whether knowledge of information discussed in other chapters is required before starting a new one. The comprehensive table of contents and index can be used to find other subjects quickly.

The presentation of the subject material is based on the principle that students should be able to study the theory independently.
To help with self-study, many clarifying examples have been provided. Students can also assess whether the material is understood with the aid of test questions. The answers to the test questions can be found at the back of the book, and let readers verify their answers and their understanding of the theory. 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 a series of multiple-choice questions.
The answers to the multiple-choice questions are found 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 degree of complexity. Answers and solutions can be found in *Answers and solutions*, on the website. A number of exercises is discussed in detail there.



Flexible learning routes
As suggested by the introduction, there are different learning routes for studying the material in this book. The first route follows the sequence of the subjects in the book, dealing first with finance, then management accounting and finally financial accounting. This is the authors' preferred reading order as it matches the consecutive order of the problems that fledgling entrepreneurs are faced with.

The second major route first focuses on the management accounting section, followed by finance and financial accounting.
This is the more traditional sequence used in the field of financial management, with the initial focus on issues concerning cost calculations.

In principle, it is also possible to start with financial accounting after the first introductory part: a rather unusual approach when studying all the topics, though the set-up of the method does allow for it.

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 determines 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 liability of the owner for the company's debts, for its fiscal position and for various other aspects. Paragraph 1.4 discusses these aspects in detail. Paragraph 1.5 covers value added tax, which all entrepreneurs have to deal with. Lastly, paragraph 1.6 discusses different forms of cooperation between companies, varying from completely abandoning autonomy to cooperative forms that leave autonomy largely intact.

1

1.1 Consumers and Manufacturers

People have many needs: housing, food, cars or bicycles for transport, help with filing their tax returns, leisure activities such as a weekend break, etc. All these products and services have to be 'manufactured'. The use of a car requires a car manufacturer; a weekend break may call for a hotel. Prior to the emergence of large-scale bartering, consumers were also automatically manufacturers: they baked their own bread and built their own housing. In developed economies, this is no longer the case.

Production organizations

Production organizations also referred to as businesses, manufacture products and services and sell these to consumers at a certain price. Consumers obtain purchasing power from the income generated by working for these companies.

Economy

The economy deals with questions connected to the ways in which people strive to optimize their 'prosperity': how can the supply of products and services be optimized using minimum resources?

Economics

Microeconomics

Economics studies the relationship between consumers and businesses and the mutual interactions between businesses. A distinction can be made between micro and macroeconomics. *Microeconomics* comprises, among other things, the theory behind markets: how does the price mechanism work in a particular market, such as the market for holiday travel? Determining factors include the number of suppliers and customers in a particular market. Markets will be briefly discussed in paragraph 1.6.

Macroeconomics

Macroeconomics studies economic problems that affect society as a whole, such as inflation and unemployment.

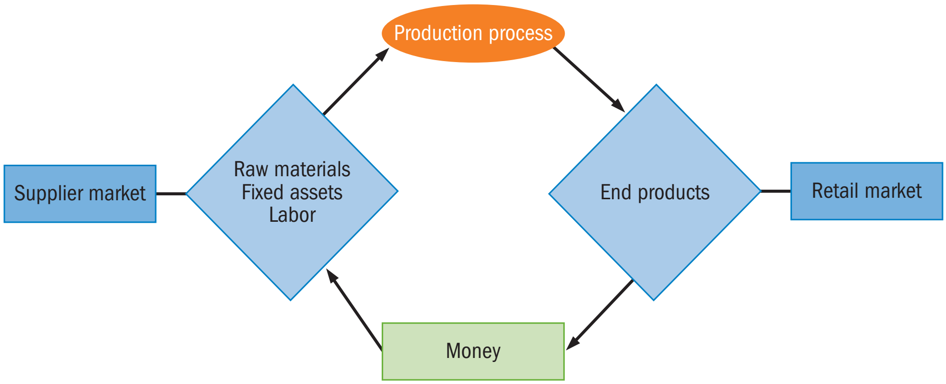
Business economics

Business economics focuses on economic behavior in a production organization. In this context, 'production' should be interpreted broadly: it not only concerns the production of physical goods, but also trade and services. In economic terms, production organizations would not only refer to car manufacturing plants but also to car dealerships or workshops, for example. Paragraph 1.3 discusses the different forms of production.
The economic system assigns an important role to production by companies. Companies are production organizations focused 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 is found below.

A company is a production organization

In a production organization, resources are combined and transformed into products during a production process.
A production organization operates between two markets: the supplier market, where resources are obtained; and the retail market, where manufactured goods or services are sold.
Resources may comprise commodities/(raw materials) on the one hand, and machines, buildings and similar things on the other. The latter category is called fixed assets or fixed assets, since – compared to raw materials – these assets remain in (service of) the company for extended periods of time. Labor, supplied by a 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 into beer through a series of processes. The water and the hops are the raw materials used for the end product: beer. In addition to raw materials, the company needs fixed assets: a building, boilers for brewing, trucks, computers, etc. Of course, employees are an indispensable link in the production chain.

A production organization is therefore a joining of the production factors particularly labor and capital. 'Capital' refers to the raw materials and fixed assets used by a company. **Capital**
A production organization can have a formal nature, with the rights and obligations of the participants laid down in writing: the empowerment of shareholders, directors and employees are described in the articles of association and in the job descriptions. The term 'production organization' can also be used to describe two students starting a courier service, for example, with the only agreements being that they will take turns in answering the phone and making deliveries.

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.

A company seeks to maximize its profit
A company participates in the economic process with the intent to make its owners 'better off'. It strives for 'value creation': the sales of the produced goods and services need to outweigh the price paid for the production factors (labor, raw material, fixed assets) at the supplier market. The owners of the company are the beneficiaries of the surplus in payment: the profit. The objective of maximizing profit is what distinguishes companies from businesses in general. Every business produces goods and/or services. The following paragraph describes those businesses without a profit target.

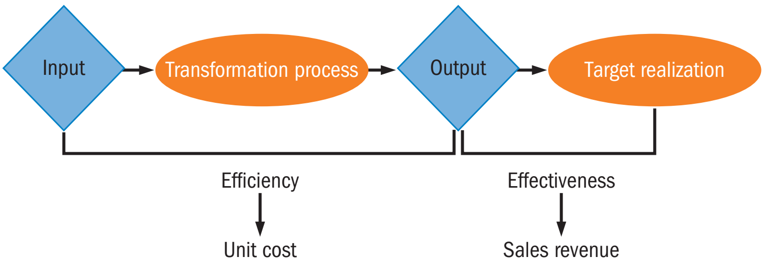
Efficiency
Effectiveness

The level of profit depends on efficiency on the one hand, and effectiveness of the production process on the other. *Efficiency* relates to the cost-effectiveness of the production process and *effectiveness* to the ability to meet target objectives of the production process, or the extent to which end products meet customer requirements. A production process is efficient if a given quantity is produced at minimum costs. It 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 every hundred liters of beer by using labor and fixed assets as efficiently as possible. The company tries to achieve the given quality standards at minimum cost. Cost is therefore a measure for efficiency.
The end product should be of such a nature that it allows the company to acquire a market share. The product's taste, price-quality ratio and 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 roles of efficiency and effectiveness in the production process are shown.

FIGURE 1.2 Efficiency and effectiveness in the production process



Profit
Sales revenue
Turnover
Costs

It is typical for a company to use profit as a measure for efficiency as well as effectiveness: after all, it is the difference between sales revenue or turnover (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 profitable prospects, the company will generally not feel any compunctions about 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.

The following information should also be kept in mind:

Continuity

- Maximizing profit 'at all cost' is usually not given the highest priority; the continuity of the company is also an important concern. However, profit is necessary to assure continuity; only a profitable company will have the required financial resources to survive independently. Concerning 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 is a counter-productive strategy in the long run.

- It may sometimes seem as though the major company target is optimizing sales revenue instead of optimizing profit. Corporate managers often appear to feel that bigger is better. Company X may be acquired by company Y without the takeover being based on any well-founded expectations regarding company X's contributions to overall profits.
- Companies generally present their own *mission statement*, outlining their targets without addressing their drive for profit as a prominent factor, instead focusing on environmental issues, job satisfaction for employees, etc. Here are several examples from major companies.

Mission statement

PHILIPS
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.

AHOLD DELHAIZE
At Ahold Delhaize, our ambition is to bring fresh inspiration every day to customers, communities and colleagues, and to make life a little easier, healthier and more affordable for everyone. We are proud of our companies' long-standing roots in local communities and commitment to the needs of local shoppers.

SHELL
We believe that oil and gas will remain a vital part of the global energy mix for many decades to come. Our role is to ensure that we extract and deliver these energy resources profitably and in environmentally and socially responsible ways. We seek a high standard of performance, maintaining a strong and growing long-term position in the competitive environments in which we operate. We aim to work closely with our customers, our partners and policymakers to advance a more efficient and sustainable use of energy and natural resources.

1.2 Profit and Non-profit Organizations

Companies focus on maximizing profit and are part of the profit sector. This book pays particular attention to that 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 mainly provides *public goods and services* for the general public, such as roads, protection against the sea and general 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

Public sector

Market mechanism

Budget mechanism

1

Privatizing

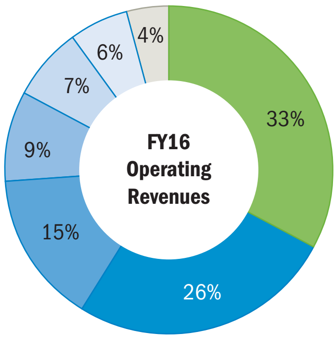
and services: the government imposes compulsory contributions (tax) and provides a budget to finance the production of public goods.
There are also general facilities that, in the past, have been offered by the government to influence their availability to a larger public, but in principle could be provided by companies. In recent years, the government has supported a trend towards *privatizing* these activities: where applicable, the activities are separated from the government and must prove themselves to be viable as part of a market. Examples are public transport, telecommunications, mail delivery and the supplying of energy.
- *Private non-profit businesses* comprise a wide variety of organizations from amateur sports clubs to charitable organizations such as the Red Cross. The latter is also known as a fund-raising institution as it attempts to raise funds to achieve a worthy social objective.

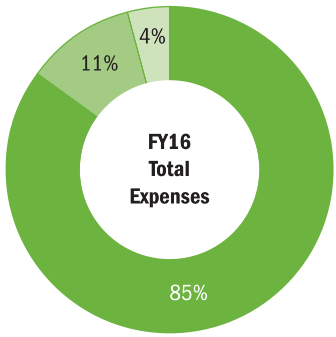
Organizations in the non-profit sector differ from companies in the following aspects:
- The target set by non-profit organizations is to provide certain (socially important) facilities. The activities they perform are connected to their social objectives. Médecins Sans Frontières/Doctors without Borders provides medical activities in developing countries because that is its reason for existence. Changing their activities based on financial reasons is not a consideration. Donors would strongly object if the organization would suddenly switch to other activities. Shareholders of a profit organization such as Unilever would not lose sleep if the production of laundry detergents were to be replaced by other activities 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 '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 the problems of its clients as much as possible. This type of aid or relief cannot be expressed in money. Effectiveness must be established in another way, for example, by registering waiting times or conducting client satisfaction surveys. Non-profit businesses can monitor their efficiency by calculating their costs. A foundation for victim aid could, for example, calculate the costs of one-hour consultations.

The subjects discussed in this book are mainly applicable to companies, although they are also relevant for non-profit businesses. This applies in particular to the subjects in the section on Management Accounting, as non-profit businesses should also attempt to work as efficiently as possible. In the section on finance, a number of the financial resources discussed, such as shares, only applies to companies. Other subjects are also applicable to non-profit organizations.

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

Income statement World Wildlife Fund 2015/2016 (year ended 30 June)





Individuals	$100,355,045	33%
In-kind and other	79,845,124	26%
Government grants	46,365,374	15%
Foundations	26,543,278	9%
Other non-operating contributions	20,493,975	7%
Network	17,934,104	6%
Corporations	13,671,189	4%

Programs	$259,505,203	85%
Fundraising	32,750,779	11%
Finances and administration	12,950,274	4%

Source: http://www.worldwildlife.org

TEST QUESTION 1.2

Were the 2015/2016 results (revenues – expenses) for the WWF positive or negative? Is it possible to conclude, based on the outcome, whether the WWF performed well in 2015/2016?

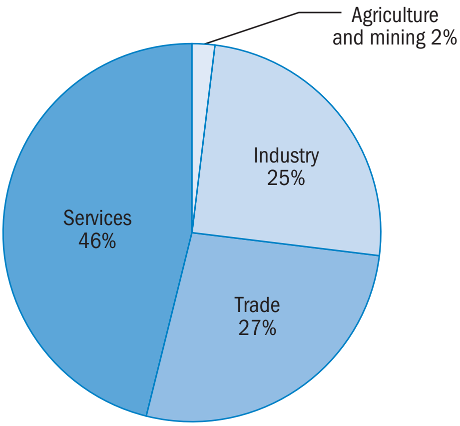
1.3 Business Activities

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.
The following classification of companies is based on the nature of the transformation process:

- agriculture and mining
- industry
- trade
- services

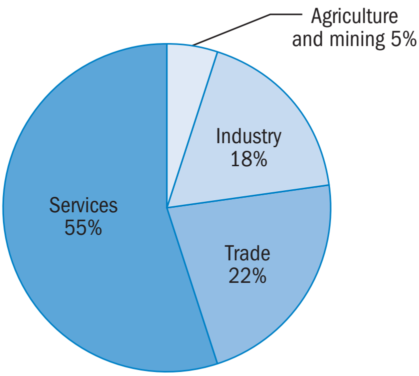
Figures 1.3a and 1.3b provide an overview of the four sectors in terms of their stake in the overall European and Dutch economy.

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



Source: Eurostat

FIGURE 1.3b Number of companies per sector in the Netherlands (2016)



Source: CBS

Agriculture and mining

Companies in the agriculture and mining sector typically use 'nature's bounty'. With a relatively small quantity of raw materials, a large quantity of end product is achieved. To a farmer, the cost of seed is merely a small percentage of the crop revenues. Mining companies involved in extraction of mineable minerals, such as gold or copper, and commodities such as gas or oil, do not use up raw materials at all as they are in the business of producing them. Obviously, fixed assets are still very important: farmland for a farmer, a concession for a mine or the oilfield for an extraction company – and there may also be a lot of equipment required.

Industry

Industrial companies create a physical, tangible product that did not yet exist before its production. There is a distinction between mass and job production. In *job production*, production is customized. Each product is

Job production

tailored to customer requirements and products are made to order: a sale is agreed upon before production starts.
Job production causes no build-up of inventory of finished but unsold products. An example of job production is a shipyard where recreational yachts are built to customer specifications.
In *mass production*, a single type of product is produced in large quantities. Specific customer requirements are not taken into account. There is usually a build-up of inventory. A sugar refinery is an example of mass production. Table 1.1 summarizes the differences between job and mass production.

Mass production

TABLE 1.1 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

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 batches, and customers can choose from the available components to create their own dream boat, this is considered 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 occasionally switches to sugar cubes, this is considered batch-mass production.

The importance of the three resources (raw materials, fixed assets and labor) varies, depending on which type of industry a company operates in. For an oil refinery, raw materials and fixed assets are a major part of the costs, whereas labor costs are a prevailing factor for a manufacturer of artisanal wooden kitchens. As automation progresses, the significance of fixed assets for total costs 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

EXAMPLE 1.3

For a Japanese manufacturer of computers, it would be problematic to sell computers directly to European consumers. Trading companies are a solution to this problem. A chain of computer stores can import many computers from Japan (1), add other articles that customers may need to the product range (2), build up an inventory to allow customers to buy a computer at any given time (3), and offer its goods closer to where the consumers live (4).

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.

Retail trade

Wholesale trade

Wholesale trade purchases from the manufacturer and redistributes the purchased goods among 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 logistics systems.
The trading costs consist mainly of the purchased merchandise. Apart from this, of course other fixed assets are also involved (buildings, cars and so on). Labor costs can also be considerable, particularly in retail trade.
Due to the emergence of online trade, there are major shifts in the trade industry overall. Retail trade, in particular, is under pressure: wholesale traders can offer their products directly to customers through internet stores.

Services

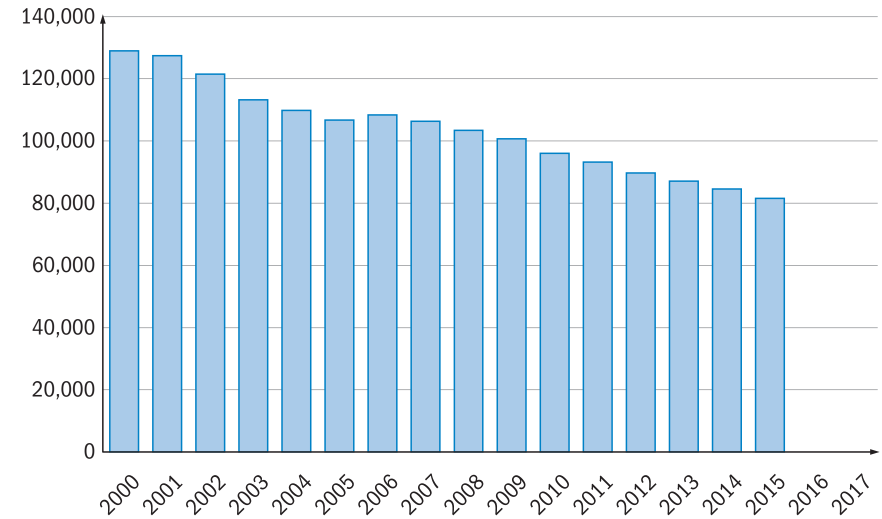
Service companies provide a service to their customers without manufacturing a new product or redistributing an existing one. This applies to companies of a varied nature.
Some important categories:

- 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 materials are purchased from suppliers. Fixed assets can be very important for service companies: consider a hotel located in the center of a major city, or a shipping company with a fleet of container ships.
Labor costs are nearly always very important since service rendering is a 'people business': consider IT-specialists working for a software company, or security guards at a security firm.

Due to increasing automation, companies in the service industry are also becoming increasingly less reliant on using staff. One example of this is in the world of banking. By encouraging self-service, in the forms of online banking or the use of ATMs, customers rarely need to visit their bank's offices in person. After all, there's nothing to be done there that one would not be able to do at home. As of 2000, there has been a downward trend in the number of employees in this industry (see figure 1.4).

FIGURE 1.4 The development of employee figures in the banking industry



Source: Nederlandse Vereniging van Banken (NVB)

According to figures by the UWV (the Dutch government institution in charge of implementing and administrating employee insurances) between 55,000 to 60,000 jobs were lost across the whole of the Dutch financial industry over the past decade. Banks everywhere are making cutbacks in their staff numbers: from HR, IT and risk management to regional offices, customer care and reception staff.

1

TEST QUESTION 1.3

The following cost ratios belong to three internationally operating Dutch companies:

	1	2	3
Raw materials	69%	72%	0%
Labor costs	21%	15%	47%
Other costs	10%	13%	53%
Total cost	100%	100%	100%

These three companies are:
- Ahold Delhaize, a supermarket chain
- ING, a bank
- Unilever, a manufacturer of nutrition and healthcare products

Which number relates to which company?

1.4 Legal Forms of Businesses

Every company has a legal form. The choice of legal form determines the nature of legal relationships within the company and legal relationships between the company and the outside world.
Important aspects determined by the legal form are:
- establishing who has ultimate control over a company's decisions
- defining the ways in which a company attracts financial resources
- a company's potential options for ensuring long-term continuation
- the extent to which owners are liable for the debts incurred by the company
- a company's fiscal position
- the extent to which the company is 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 an independent party in legal agreements made during business transactions. It may hire staff, conclude a sales agreement and borrow from a bank. Private individuals are, of course, required to conclude such an agreement on behalf of the legal entity.
If a company is not a legal entity, the agreement is made in the name of the owner.

Sole proprietorship

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 (corporation), bv (limited liability company) and coöperatie (cooperative).
In the US, business corporations can also be non-profit organizations.
There are two different types of non-profit organizations: foundations and associations. In the Netherlands, foundations and associations are both legal

entities. An elected board acts on behalf of the organization. These legal entities are not further discussed in this book.
Over the course of the following paragraphs, the properties of the different legal forms are explored.

Sole proprietorship
In a sole proprietorship, the owner is also the management. The owner status is derived from having made the investment of the capital used to run the company. It is possible for an owner to have invested not just his own capital, but to also have taken out a loan. However, this loan does not give the lender (usually a bank) control of the business.
Of course, there may be several persons working in a company with sole proprietorship, although these would then be members of staff employed by the owner.
A sole proprietorship depends entirely on the entrepreneur. If the entrepreneur becomes 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 the company, a successor must be found, from among either relatives or outsiders.
As previously mentioned– and discussed in detail in the financing part – a company can be financed with capital invested by the owner or by loans. The first method of financing is using the owner's *equity*; the second method is using *liabilities* or debts.

Equity
Liabilities

The size of a sole proprietorship is normally limited, due to the limited availability of equity.
When a company is created, the owner must invest private assets; strengthening the company's financial position can be done by retaining profits. This implies that profits cannot be used for private purposes by the owner but remain in the company.
As it is the entrepreneur in his or her personal capacity and not the company who enters into legal agreements, the entrepreneur is liable for the debts incurred by the company.

EXAMPLE 1.4
A starting entrepreneur has invested her savings in a hairdressing business. She borrows the remaining required capital from the bank. The business fails to attract enough customers. The entrepreneur cannot meet the 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 demands the entrepreneur uses her private assets to clear the debt. Under extreme circumstances, this could result in the entrepreneur's car or house being sold.

Income tax

An 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.

1

The Dutch income tax system has three different tax boxes. Income is taxed progressively in box 1, which includes social security (in particular, as a consequence of the General Old Age Insurance Act). Box 2 documents all income derived from substantial shareholding (see companies with share capital) and box 3 holds all income derived from savings and investments. As, in fiscal terms, profit acquired by a sole proprietorship is considered the income of the entrepreneur, profit is taxable in box 1.

BOX 1 Income tax rates (2018)

Tax bracket	Taxable income	Tax percentage
1	Up to €20,142	36.55%
2	From €20,143 up to €33,994	40.85%
3	From €33,995 up to €68,507	40.85%
4	From €68,507 and upwards	51.95%

Entrepreneurial tax deduction

Self-employed tax deduction

Startup tax deduction

SME exemption

Entrepreneurs are entitled to various fiscal advantages. One of the favorable arrangements is the *entrepreneurial tax deduction*, consisting of the self-employed and startup tax deductions, which allows entrepreneurs to deduct an amount from their profit. In 2018, the self-employed tax deduction was €7,280. This amount is increased by the startup tax deduction, an amount of €2,123, for the first year of a new business. For any profit above this amount, 14% (2018) is exempt from taxation – this is known as the SME exemption.

Furthermore, every taxpayer liable for income tax is entitled to a reduction on the amount of tax to be paid. The general tax credit depends on the amount of taxable income, as shown in this table:

General tax credit (2018)

Taxable income		General tax credit
From	Up to	
€0	€20,142	€2,265
€20,142	€68,507	€2,265 – 4.683% × (taxable income – €20,142)
€68,507	–	€0

All persons with income deriving from work activities are entitled to an additional labor tax credit. The labor tax credit is based on taxable income. For the entrepreneur, this is the profit prior to the self-employed deduction and the SME exemption.

Labor tax credit (2018)

Work income		Labor tax credit
From	Up to	
€0	€ 9,468	1.764% × work income
€ 9,468	€ 20,450	€167 + 28.064% × (work income – €9,468)
€ 20,450	€ 33,112	€3,249
€ 33,112	€123,362	€3,249 – 3.6% × (work income – €33,112)
€123,362	-	€0

In addition, there are additional tax credits for people in particular circumstances, for example, single parents, young disabled persons and pensioners. These types of credit fall outside the scope of this book.

Schematically, the calculation of the amount of tax payable by the entrepreneur is:

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

TEST QUESTION 1.4

Mr Van Damme has a sole proprietorship in the Netherlands and acquires a profit of €40,000 in 2018.
Van Damme has no other income. Calculate the actual amount of tax he has to pay.

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, the sole proprietorship has no disclosure requirements.

Accounting obligations

The partnership

If two or more persons decide to work together in a business without a legal entity, this is called a partnership.
For professionals such as doctors, lawyers, accountants and similar the Netherlands have a special form of partnership: the professional partnership (maatschap). The owners of a partnership will henceforth be referred to as partners. Unless stated otherwise, the information provided also applies to professional partnerships.

The control of the business is held by its joint partners. The advantage of a partnership is that each partner may have 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 the continuation of the partnership. The loss of a partner is not necessarily fatal for a business, but differences of opinion may lead to a premature ending of the business.
It is possible to acquire extra equity by offering new partners the possibility of buying themselves into the business.
The partnership has a separated capital, which implies that business creditors have priority over individual partner creditors in the event of defaults.

Jointly and severally liable

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. 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.

1

EXAMPLE 1.5

The partnership Smith & Jones trades in antiques and curios. Each partner holds 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 revenue from 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 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

Limited partners

Silent partners

The general partnership is run and owned by the same persons. The *limited partnership* has a partial separation of ownership and control: limited partners, also known as silent partners, can be owners of a business because they invested capital, but they do not control the business. The general partners in a limited partnership are both owners and in control. An advantage of a limited partnership is that it comes with the opportunity to attract extra capital without the risk of disputes among partners. Limited partners are not liable to meet the debts of the business with private assets. Limited partners also pay income tax on their share of the profit. Unlike the general partners, however, they are not entitled to the fiscal advantages granted to sole proprietorships.

Joint-share companies

Limited liability company

Corporation

Limited Company

Public Limited Company

A joint-share (joint-stock) company is a legal entity with limited liability. In the United States, the limited liability company (LLC) and the Corporation (Inc.) are examples of joint-share companies.
In the UK the corresponding names are Limited Company and Public Limited Company. In the Netherlands besloten vennootschap (bv) and naamloze vennootschap (nv). In joint-share companies a legal separation is made between ownership and control.
In the following paragraph, the mutual characteristics of the joint-share companies are discussed, followed by the differences between the two types of joint-share companies.

Shares

Annual general meeting of shareholders

The equity of a 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 by and during the annual shareholders meeting. The board of directors handles daily management.

One of the differences between an LLC and a corporation, 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 corporation is usually created with the purpose of gathering large capital. There will be many shareholders not involved in day-to-day business management; however, larger LLCs can also make a clear separation between ownership and control.
It is possible that there is a third body, in addition to the AGM and the board of directors – the supervisory board (SVB). The SVB supervises the board of directors on behalf of the shareholders.
In many countries, including the Netherlands, the management of companies is subject to certain rules. These rules are known as the Corporate Governance Code. The fundamental principle behind *corporate governance* is that companies should be run properly, and demonstrably so. This refers to the way in which company management takes into account other interests than those of the company, such as the interests of shareholders, employees and society in general. In short, it deals with the nature of good governance, and how to ensure, monitor, and demonstrate this good governance adequately to interested parties.

Corporate governance

Both the LLC and corporation can acquire additional equity if the AGM decides to pass up on dividend payments and retain 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 obligated to compensate the company's debts with their private assets. Nor can management be held accountable for a company's debts, unless there has been identifiable mismanagement. In that case, responsible parties can be obligated to apply their private assets.

The taxation of profits of LLCs and corporations is rather complicated, as both the company and the shareholders are taxed. Corporate tax is paid on the profits of both LLCs and corporations. Shareholders pay income tax on their share of the profit.

Corporate tax

Every 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 profit, and the shareholder pays income tax on dividend. As a result, all dividends paid are 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 their share of company profit and can deduct the tax that was already paid on their behalf from the amount of income tax they have to pay. The difference between the two systems is illustrated in this 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%.

1

Under the classical system, the corporate tax and the income tax are applied independently. The LLC pays 20% × €100,000 = €20,000 in corporate tax. The profit after tax is €80,000. This profit is paid to the shareholders, who pay 25% × €80,000 = €20,000 income tax on this amount. The total amount of tax paid is €40,000.
Under the imputation system, there would also be €20,000 in corporate tax; however, this can be deducted from the income tax of the shareholders. The income tax for the shareholders would amount to 25% × €100,000 = €25,000 over the total profit before tax. As the LLC already paid €20,000, the shareholders would 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 (2018)

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

Fiscally speaking, it is possible to offset losses incurred in one year by profits from another year in order to lower payable taxes – this is known as the loss offset.

Loss offset

A loss from a particular year can be calculated in either of two ways:
- The loss is offset by the taxable profit from the previous year. This is known as loss carry back.
- The loss is offset by the profits from no more than 9 subsequent years. This is known as loss carry forward.

Loss carry back

Loss carry forward

In principle, losses have to be offset by the profit from the preceding year. Companies are only allowed to carry a loss forward if there is no possibility of offsetting the loss against profit from the preceding year.

The shareholder pays income tax over the distributed profits. 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*. They are taxed in box 2 of the income tax (rate for 2017: 22% up to €250,000 and 25% for everything above that amount) on the dividend they receive from the company and for possible profit on share sales. This implies that, on each Euro of profit, at least 37.6% is paid in tax, with the initial 20% in corporate tax on the profit paid by the company, and the remaining 17.6% in income tax (22% of 80%) paid by the shareholder.
The LLC often only has one shareholder, who then becomes the managing director and sole shareholder. The salary of the managing director/shareholder is a cost to the company and deductible for corporate tax.

However, the managing director/shareholder must pay income tax on his salary. The dividend received by the managing dirrector/shareholder is not a cost – it is profit distribution, taxed in box 2.

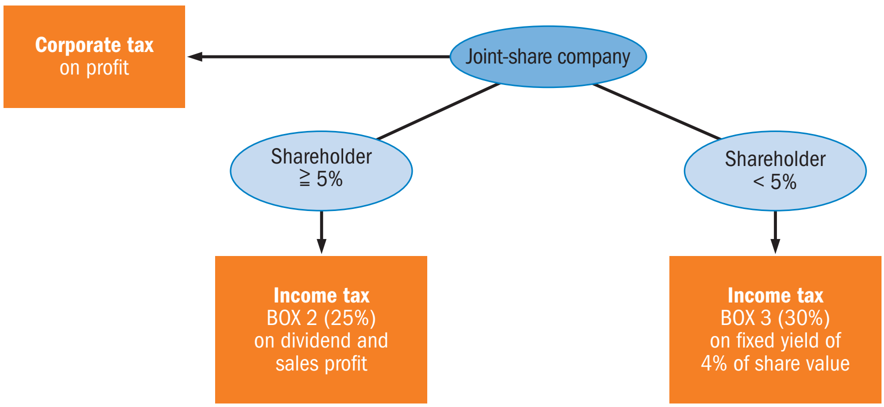
A shareholder with less than 5% of shares will be taxed in box 3 of the income tax system. This box assumes a revenue in the form of a fictional interest rate returned from capital as that capital increases. Therefore, the actual revenue is not important. The assumed revenue is taxed at 30%. Income up to €30,000 is tax exempt. The next €70,800 is subject to an assumed interest of 2.02%; the next €907,200 after that is subject to an assumed 4.33%; and any excess to an assumed 5.38% (2018 percentages).

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. Talk (with 97 shares) and P. Hasseldorf (with 3 shares). The market value of one share Ferry LLC is €25,000. The LLC pays corporate tax over €120,000, being: 20% of €120,000 = €24,000.
J. Talk is a substantial business interest holder; he has to pay income tax on €77,600 (97% of €80,000). In box 2, this amount is taxed at 25%, being €19,400.
The dividend of P. Hasseldorf is taxed in box 3. The value of his share package is €75,000. The first €30,000 investment is tax exempt. The next €45,000 is subject to an assumed interest of 2.02% × €45,000 = €909, on which he pays 30% × €909 = €272.

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

FIGURE 1.5 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, however, as the shareholder can offset the paid dividend tax against the payable income tax.

Both the LLC and corporation 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 corporation

The three major differences between both forms of joint-share company are:

1. LLC's shares are always *registered shares*. A corporation has the possibility of issuing *bearer shares*, which can easily change legal owners. Stock exchange listed companies are therefore always corporations.
2. **Blocking clause** An LLC can enter a *blocking clause* into the articles of association, putting restrictions on selling shares. A shareholder intending to sell could, for example, be obligated to offer his shares to the other shareholders first. A corporation cannot restrict the sale of shares.
3. In the Netherlands the creation of a corporation requires an initial minimum capital of €45,000. There is no required minimum capital for setting up an LLC.

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

Country	Similar to LLC		Similar to corporation	
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 company	Ltd	Public limited company	PLC
United States	Limited liability company	LLC/ Co.Ltd	Corporation or Incorporated	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. In a *production cooperative*, the members are suppliers of raw material for the production process. In a cooperative dairy, the members might

supply milk; in a cooperative sugar refinery, they might supply sugar beets.
2 In a *purchasing cooperative,* members buy their supplies such as seeds, propagating material or fertilizer from the cooperative.
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 a 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 or corporation.

TEST QUESTION 1.5
The bond between the members and the cooperative is usually much tighter than that between shareholders and their corporation. What could be the reason for this?

Traditionally speaking, cooperatives were mainly to be found in the agricultural and financial industries. These days, cooperatives may also be found in other industries, with an example being a windmill owner cooperative in the energy industry.

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 set its prices below 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 corporation, members of a cooperative usually have limited liability for the debts of the cooperative. In the Netherlands, there are three legal forms of cooperatives:
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.

A cooperative’s profit 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.

Table 1.2 summarizes the characteristics of the different legal forms.

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
Corporation	Yes	Yes	New issue of shares	Independent existence as legal entity	Limited to amount of contribution of private assets	Corporation: 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

1.5 Value Added Tax

This paragraph discusses value added tax (VAT), which all companies in Europe and in most other countries have to deal with, regardless of its 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. Value Added Tax is included in the paid price. 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 at least 5%.

In the Netherlands, the standard rate for value added tax is 21%, and there is a reduced rate of 6% on food and certain services. The applicable rate is added to the selling price of a product or service. The company transfers the tax to its customers by increasing the selling price by the amount of tax due. Tax is due regardless of whether the delivery is to an end consumer or to another company. If the buyer is a company, it is entitled to reclaim the charged VAT. If the buyer is an end consumer, they cannot reclaim the tax. The tax 'sticks' to his purchase.

EXAMPLE 1.8

A manufacturer of household appliances produces air fryers at a cost of €100 each. They sell the air fryers to a wholesaler at €150 each. The wholesaler sells them to a retailer at €170 each, and the retailer resells the article to the end consumer at €200 each.

If the manufacturer sells one air fryer to the wholesaler, they pay 21% of €150 = €31.50 in value added tax. They charge this to the wholesaler, who receives the following bill:

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

The wholesaler sells the air fryer to the retailer at €170; they pay 21% of €170 = €35.70 in value added tax, and 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 in value added tax paid to the manufacturer. As a result, they 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 fryers to the consumer at €200 each. The consumer pays 21% of €200 = €42 in value added tax. The consumer is billed 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 the following table.

Tax consequences for the entrepreneurs

		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 conclusions can be drawn:

- 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 eventually charged to the consumer. In the given example, the consumer will be charged €42, which they cannot reclaim. For consumers, value added tax is a *cost-increasing tax*.

Cost-increasing tax

VAT does not play a role on the income statement (see chapter 3). Both revenues and costs are shown without VAT.
Normally, the tax authorities require that VAT be settled every three months, at which point the balance of payable and claimable value added tax is paid to the tax authorities (or received from those authorities if the claimable VAT is more than the payable VAT).

TEST QUESTION 1.6

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

Special circumstances for value added tax

- *Exemptions*

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

1. The company is not liable for value added tax on the product or service they provide.
2. The company cannot reclaim value added tax they pay to suppliers.

In fact, a 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 relates to consumptive expenditures within a particular country. Products sold from the Netherlands to other countries are not subject to value added tax in the Netherlands. These products will be subject 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 subject to 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 the paid value added tax if the imported products are used for taxable services.

1

1.6 Types of Cooperation between Companies

Companies can cooperate to 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 are discussed in the following paragraphs: mergers and takeovers, franchising and cartels.

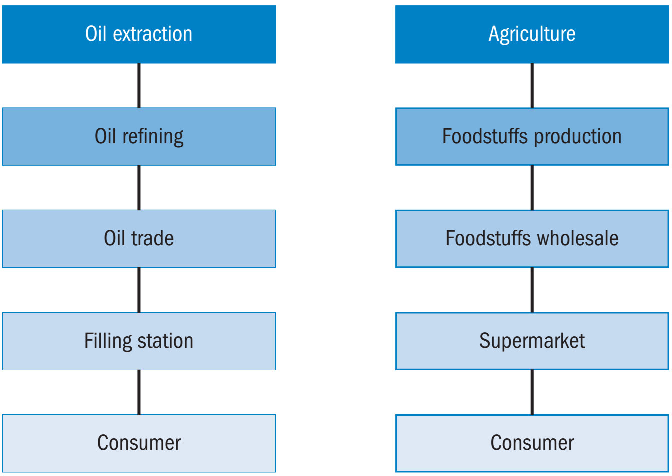
Mergers and takeovers

If a company wishes to grow, one option would be to start new activities. However, it is often easier to take over an entire company rather than pursue autonomous growth. **Takeover** Takeovers are normally achieved by one company buying the shares in another company. A merger is a situation in which two equal parties join together.

The difference in relationship between the acquirer and acquiree is best explained using terminology from industry and supply chain. **Supply chain** A supply chain is the total chain of companies involved in the production of a product or service. It concerns all stages of the combined process that a product follows on its way from producer to consumer. The companies that operate at one level of the supply chain form what is known as an industry.

Figure 1.6 shows two supply chains.

FIGURE 1.6 Supply chains



There are distinctly different types of takeovers and mergers, namely:

1 Acquirer and acquiree operate in the same industry. If a chain of gas stations were to take over another chain of gas stations, this could offer advantages in terms of less competition and a reduction in costs, for example, through economies of scale.
2 Acquirer and acquiree operate at consecutive levels of the supply chain; for example, if an oil extraction company were to take over an oil refinery. **Vertical integration** This is called *vertical integration*. Vertical integration is common practice

in 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; for example, if an oil wholesaler were to take over a wholesaler in another industry, for example, food (which can be used to supply stores at gas stations). Such a takeover is an example of *horizontal integration*, widening the assortment. **Horizontal integration**

4 Acquirer and acquiree operate at different levels and in different supply chains. In the past, many takeovers were used to create conglomerates: business groups active in various levels of various supply chains. The idea was that it would be 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 are focusing on their core business and selling off other parts of the company. **Conglomerates**

Franchising

The format that is characterized by a single entrepreneur joining a chain and using 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 were an independent entrepreneur, but profile the business activities 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 in services.

Cartels

Cartels are agreements between manufacturers; they are designed to restrict competition. The opportunity to draw up such agreements depends on the market structure in which the companies operate.
In a perfectly *competitive market*, there are many companies offering a standardized product to many customers. This results in harsh competition. **Competitive market**
The other extreme is a *monopoly*, in which there is only one provider and therefore no competition. **Monopoly**
Cartels do not exist under either competitive markets or monopolies.
An *oligopoly* is a market with relatively few providers. Road construction is a good example. **Oligopoly**

TEST QUESTION 1.7

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

In an oligopoly, companies can easily be persuaded to collude and make price agreements with one another. They could even divide the market between them. This behavior is what gives rise to a cartel situation. Due to the potentially damaging effects for consumers, the European Union has made fighting cartels a top priority. Cartel agreements are illegal under European Competition Law, and the European Commission heavily fines companies found participating in such agreements. As cartel agreements are illegal, they are made secretively, and it is difficult to prove their existence. The Leniency Notice encourages companies to provide inside information on cartel agreements to the European Commission.

Whichever participant in a cartel agreement is first to inform the European Commission is then exempt from any 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 are part of general economics but, of course, have important consequences for business economics.

For fourteen years, Europe's major truck manufacturers made illegal price agreements. Initially struck in the fringes of truck fairs, these agreements were followed up by phone calls once the top level managers returned to the Netherlands, Germany and Italy. The cartel moved to the digital highway following the ubiquitous spread of email and the internet in 2004. In July 2016, the European Commission slapped five manufacturers with a record fine for their role in the cartelization between 1997 and 2011. DAF, Volvo/Renault, Daimler and Iveco settled their cases, and have been required to pay a combined €2.9 billion for striking illegal price arrangements relating to the introduction of a new exhaust norm, and for delaying the introduction of cleaner engine technology. MAN, the cartel whistleblower, has not been fined. Scania refuses to acknowledge any fault, and is now involved in a separate legal procedure.

Glossary

Business corporation	Company with a legal entity status and usually freely transferable shares, divided capital equity.
Business economics	Discipline in economics that studies economic behavior in companies.
Capital	The production factor consisting of raw material and fixed 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 one level of 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.
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.
Sole proprietorship/ sole trader	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 corporation, will be taxed in box 2 of income tax.
Supply chain	A chain of companies that succeeds one after another in the production process.
Value added tax (VAT)	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 for 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 organizations.
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 organization 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 legal forms has *no* financial disclosure requirements?
a Partnership.
b Corporation.
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 offers 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 a general 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, at €20 each. He sells 700 radios in the Netherlands at €30 each and exports 300 radios to Belgium at €40 each. All prices exclude 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 Perfectly competitive market.
d All named markets.