Basics of Financial Management

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Second edition

Noordhoff Uitgevers Groningen/Houten

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Preface

Basics of Financial Management offers a complete introduction to the disciplines of finance and accounting. It can be used by first-year students enrolled in higher education programmes in business administration or other academic programmes that require a basic understanding of financial management.

Basics of Financial Management is the international version of the *Basisboek Bedrijfseconomie,* a successful textbook for the Dutch higher education market for more than twenty years. It is not just a translation. The topics in the book have been adapted to an international, mostly European, context. The second edition of *Basics* corresponds to the ninth edition of the *Basisboek*.

Our aim is a student-centred approach, using clear language and terminology, a logical theory structure, including many examples, illustrations and test questions to ensure that students absorb the study material as effectively as possible. New is the use of photos with accompanying text, to build a bridge between theory and business practice.

In order to make the book more adaptable, we have re-arranged the topics. Part 1, Financial Management in Business, now offers a better introduction to financial management. The characteristics of businesses are explained; the basic terminology and principles are introduced; the finance and accounting disciplines and basic financial statements are explained. After studying the first part, students may study the other parts of the book in any order. The other parts discuss the topics of finance, management accounting and financial accounting.

With regard to topic selection, we have been guided by the needs of the target group. Some topics that were included in the first edition have been deleted and other topics have been added on the basis of comments made by users of the book, both students and professors.

The book is accompanied by a separate *Exercises* book and a website, which contains updated additions and extra training and exercise material.

In this edition the team of authors has been reinforced by Olaf Leppink.
He is primarily responsible for the *Exercises* book and digital support resources.

We hope this publication fully meets the needs and wishes of all users.
Any comments or suggestions are warmly welcomed.

The authors
Teteringen, Zwolle
Spring 2011

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Introduction

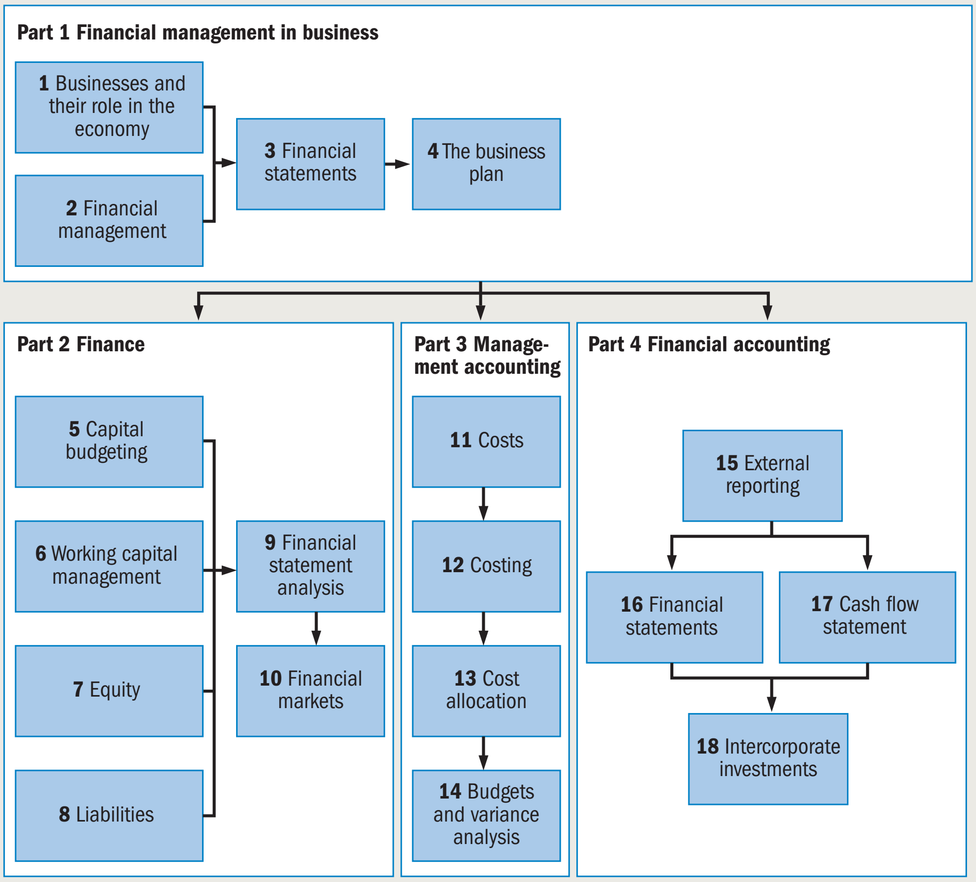
Basics of Financial Management covers all the topics that are relevant to professions in which a basic knowledge of financial management is needed. The course book is also suitable for students wishing to subsequently undertake more in-depth study.

To promote the user-friendliness of the book, we have provided a brief explanation of its structure and potential uses below.

The book is split into four parts: 1 Financial Management in Business, 2 Finance, 3 Management Accounting and 4 Financial Accounting.
The first part provides an introduction to some basic terms and principles of financial management. Readers are advised to start with this part.
With this knowledge the other three parts can be studied independently.
To support those students who wish to study a specific topic, for example because they are enrolled in a problem-based or project-based course, a diagram, mapping out the relationships between the chapters, has been included in this introduction. This diagram is designed to help students assess whether knowledge of other chapters is required before starting on a chapter or topic. A detailed table of contents and an index have also been included to enable topics to be easily searched.

The study material has been presented in such a way that students should be able to learn the theory independently. To aid self-study, numerous practical examples and test questions have been included in the text, so that students can assess whether they have understood the material. To illustrate its practical relevance, newspaper cuttings, parts of annual reports and photographs with accompanying text have also been included.
Key terms are shown in the margin to emphasise their relevance. Each chapter is concluded with a glossary and multiple-choice questions.
Answers to the multiple-choice and test questions are included at the back of the book.

We recommend the testing of your knowledge with the use of the separate *Exercises book* and additional exercises from the *Basics of Financial Management* website, which is regularly updated and supplemented by the publisher.



Flexible learning pathways

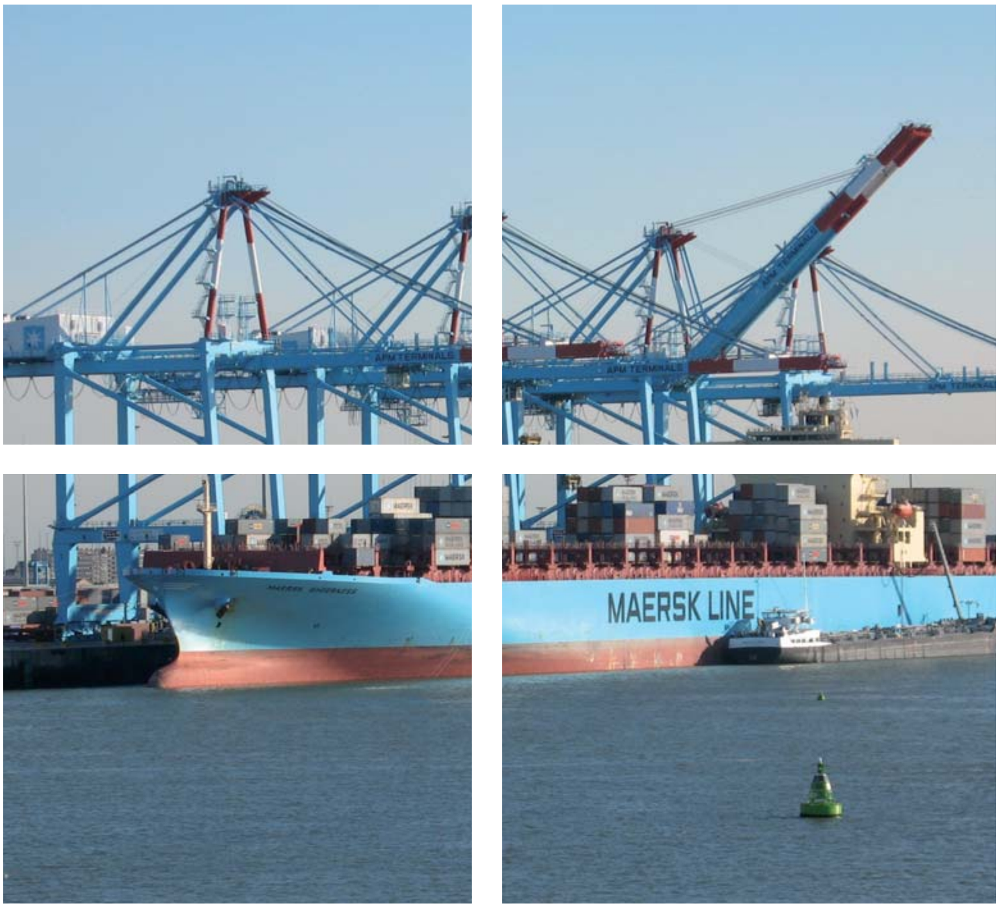
It should be clear that the study of this course book can be approached in various ways. We suggest some 'learning pathways' that will cover all the material contained in this book. The first pathway follows the structure of the book, first studying Finance, then Management Accounting and lastly Financial Accounting. The authors have chosen this order to reflect the successive problems facing start-up entrepreneurs.
In the second main pathway, Management Accounting is studied before Finance and Financial Accounting. This is the more traditional order.
In principle, after the introductory part, one could start with Financial Accounting. However, this is an unusual approach, although the structure of the book allows it.

PART 1

Financial management in business

Financial management is focused on financial aspects of running a business. Businesses behave in an economic way: they try to realize their goals by acting as efficiently as possible. Businesses produce goods and services. Assets are used in the most effective and efficient way to produce these goods and services.
Organizations striving for profit are called businesses, companies or enterprises. In this book the terms business and company are both used to illustrate financial management techniques. Most techniques can also be applied in non-profit organizations.
In chapter 1, we take a closer look at businesses. We will discuss types of business activity, distinguishing in particular mining and agriculture, manufacturing, trading, and the services sector. The type of activity a business is engaged in determines which assets it must invest in and the cost structure. Businesses can also be classified according to their legal form. When starting a business, one has to choose a legal form. The business may be a sole proprietorship or, for instance, a limited liability company. The financial consequences of this choice may be far-reaching: the amount of tax the company has to pay on its profits is just one example of the consequences. In chapter 1 we will also highlight some forms of association between businesses, including mergers and takeovers.
In chapter 2, we will discuss the three distinct disciplines within the broad area of financial management. *Finance* is focused on business investment in assets and the financing of these assets. *Management accounting* deals with the provision of financial information to the management of the business. The information has to enable management to take the right decisions. Important topics in management accounting are cost accounting and budgeting. *Financial accounting* is concerned with the disclosure of financial information to external stakeholders, such as shareholders and employees. The annual report plays an important part in this disclosure. In chapter 2 we also look at job opportunities in financial management.

Chapter 3 explains two types of financial statement used to describe the financial position of a business. The balance sheet lists the assets a business owns and the capital that is used to finance those assets. The profit and loss account lists revenues and costs over a period, resulting in a profit or loss. The financial statements are the most important part of the annual report of a business.
If one wants to start a business, one needs a good plan. Chapter 4 discusses the business plan, which is a summary of the entrepreneur's aims. Which activities will the business develop, who are its customers, what are its unique selling points? These are marketing questions. The entrepreneur will also have to make financial plans: what investments are necessary, how should they be financed, what revenue will be generated and what will be the costs? The financial elements of the business plan result in a projected balance sheet and profit and loss account.


MAERSK LINE

1 Businesses and their role in the economy

A business can be defined as a profit-based production organization. Section 1.1 highlights the elements that make up this definition. The essential differences between businesses and non-profit organizations are outlined in section 1.2. This section is intended to clarify that most business techniques can also be applied to non-profit organizations.
In section 1.3 four types of business activity are discussed: agriculture and mining, manufacturing, trading, and service. Businesses need a legal form to enable them to exist. The choice of legal form is important for the liability of the owner(s) and for their fiscal position. In section 1.4 the most common types of legal form are highlighted. Section 1.5 explains value added tax; this is a tax all businesses in Europe have to deal with.
The different ways in which businesses can collaborate is the topic of section 1.6.

1

1.1 Consumers and manufacturers

People need many things to live comfortably: a house, food, a car or a bike, help with submitting their tax returns, relaxation (weekend breaks) and so on. All these goods and services need to be 'manufactured'. Car manufacturers supply our cars, while hotels allow us to relax on our weekend break. Before the advent of the large-scale barter economy, consumers were also manufacturers: they baked their own bread or built their own houses. In our developed economy, this is no longer the case.
Manufacturing companies manufacture goods and services, which are then sold on to the consumer. The consumer, in turn, has the requisite purchasing power, as he is employed by a manufacturing company.
Economics is concerned with all issues relating to man's quest for 'prosperity': how can goods and services be offered as efficiently as possible, i.e. using as few resources as possible.

Economics

Economics is concerned with consumer–manufacturer and manufacturer–manufacturer relationships. A distinction is made between micro- and macro-economics. *Micro-economics* seeks to analyze – among other things – market forms: how are the prices in any given market, for example the world travel market, determined? The essential factor is supply and demand. Section 1.6 briefly describes the different market forms. *Macro-economics,* conversely, is concerned with the economic problems that affect society as a whole, such as inflation and unemployment.

Financial management

Financial management is concerned with the economic activities within a production organization. It takes a very broad interpretation of the term 'production', denoting not only the production of physical goods, but also trade and the provision of services.
Consequently, the car manufacturer is only one of many production organizations. The car trader and the car mechanic, offering a repair service, are production organizations as well. Section 1.3 discusses the different types of production in more detail.
The economic system assigns an important role to production in businesses. A business can be defined as an economic unit that aims to sell goods and services to customers at prices that will provide an adequate return to its owners. In other words: businesses are production organizations that are specifically geared towards generating income in the marketplace (they strive for profit).
We shall now focus on the two main elements that define the concept of a 'business'.

A business is a production organization

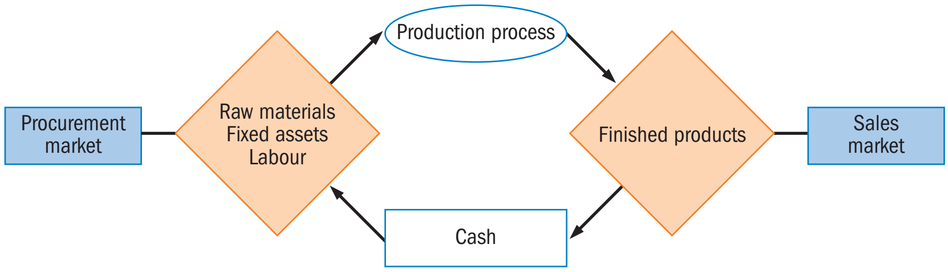
A production organization combines production resources and transforms them into end products (the production process). In other words, a production organization operates between two markets: production resources are acquired in the procurement market, and the manufactured goods are sold in the sales market.
Production resources may consist of natural resources/raw materials on the one hand and buildings, machines, etc. on the other. The latter are called *fixed assets* or *long-term assets,* because they last longer than raw materials.

Asset

Assets are economic resources. Anything tangible or intangible that is held to have positive economic value is considered an asset. Of course, the company's workforce is a production resource as well.

Figure 1.1 represents the production process in diagrammatic form.

FIGURE 1.1 Production process



EXAMPLE 1.1
A brewery purchases malt, hops and water and processes them into beer. The water, the malt and the hops are the raw materials used for the end product: beer. In addition to raw materials, the company also needs fixed assets: business premises, vats in which to prepare the beer, lorries to transport it, computers, etc. Employees are of course also a vital chain in the link.

The organizational structure of the business can be formal, setting out the rights and obligations of the participants: the powers and responsibilities of shareholders, managers and employees are laid down in the articles of association and job descriptions. A production organization can, however, also consist of a group of students starting a courier service and agreeing only to take turns in answering the phone or delivering products on a scooter.

TEST QUESTION 1.1
The owner(s) and employees are the direct participants in the business. Broadly speaking, we can identify more than two participants with an interest in the success of the business.
Name three other participants.

Businesses strive for profit

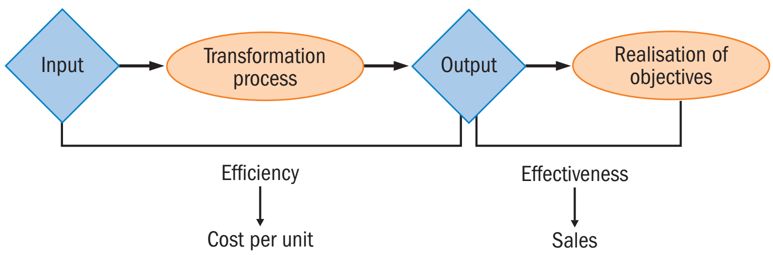
Businesses participate in the economic process for 'self-improvement.' They strive to 'create value': the net proceeds from the sale of the manufactured goods or services must outweigh the price paid to the procurement market for the production factors (labour, raw materials, fixed assets). This surplus, the profit, is awarded to the business owners.
The amount of profit depends on efficiency on the one hand, and on the effectiveness of the business process on the other.
The term *efficiency* relates to the cost of the production process. An *efficient* production process manufactures a given quantity of products with the least possible costs. **Efficiency**
Effectiveness relates to the purpose of the production process, i.e. the degree to which the end product fulfils the requirements and wishes of the end **Effectiveness**

buyer. An *effective* production process manufactures an end product that is in high demand with customers, i.e. the customers are more than happy to pay for it.

EXAMPLE 1.2

The brewery in Example 1.1 strives to produce a hectolitre of beer by deploying labour and assets as efficiently as possible. The business will strive to keep its costs as low as possible. Cost per unit is therefore a yardstick for efficiency.
The finished product must be of a sufficiently high standard to enable the business to gain a share of the beer market.
The taste of the beer, the price:quality ratio and brand positioning (through advertising) are contributory factors. The degree to which the brewery manages to generate sales revenue determines the effectiveness of the business. The roles played by efficiency and effectiveness in the production process are shown in Figure 1.2.

FIGURE 1.2 Efficiency and effectiveness in the production process



Businesses characteristically use their profit figures as a yardstick for measuring efficiency and effectiveness: after all, profit is the healthy balance between sales (yardstick for effectiveness) and costs (yardstick for efficiency).
Generating profit is the number one priority of a business; how this profit is achieved is of secondary importance. For example, a shipping company that no longer sees any profit potential in its shipping operations would in principle have no problems turning its attention to another activity. Although some employees will bemoan the loss of the company's proud shipping tradition, financial considerations have priority.
Profit is the ultimate objective; the company's activities and operations are purely a means to the end of generating profit.
When a shipping company concludes that the shipping business no longer generates a profit, it should have no problem in switching to another type of activity. Of course, some employees will regret the loss of a rich history of shipping industry, but economical considerations come first.
The following factors must, however, also be taken into account:

Continuity

- Generally speaking, entrepreneurs do not strive for profit 'at any cost.' The *continuity* of the business is equally important. For the company to secure its future, it is essential that it generates profit; only then will the business have the financial means to survive independently. To guarantee the continuity of the business, it is essential that profit is viewed in a long-term perspective: making 'a fast buck' by offering inferior products as top quality will be counterproductive in the long run.

- Most businesses have a *mission statement*, which outlines their goals and philosophy. Profit is usually not a prominent objective, unlike environmental factors, an enjoyable working environment, etc. Needless to say, a mission statement can also be used to 'show off' to the outside world.

Mission statement

EASYJET.COM

easyJet mission statement

To provide our customers with safe, good value, point-to-point air services. To effect and to offer a consistent and reliable product and fares appealing to leisure and business markets on a range of European routes. To achieve this we will develop our people and establish lasting relationships with our suppliers.

- At times, it appears that striving to generate the highest possible profit is secondary to striving to achieve the highest possible sales. For company directors, the dictum 'the bigger the better' all too often rings true. Businesses are taken over, despite an almost complete absence of any well founded expectations that the business will generate additional profit.

1.2 Profit and non-profit organizations

As businesses strive for profit, they are part of the profit sector.
This book concentrates mainly on the profit sector. However, there are also a significant number of non-profit organizations. We can make a distinction between 'public' and 'private' non-profit organizations.

- The *public sector* is arranged on three levels: national, regional and local. The public sector is primarily concerned with providing *public-sector goods and services*; these facilities are intended for the population as a whole, such as infrastructure and safety. These facilities cannot be provided by private enterprises due to the complete absence of *market mechanisms*: after all, it is impossible for a consumer to construct a motorway section for his own personal use. To provide public-sector goods and services, it is essential to levy taxes to finance their production. Certain facilities provided by the government could in principle also be provided by businesses: in addition to government-funded schools, private educational and training institutions exist.
  In recent years, there has been a growing trend towards *privatization*: all operations and activities deemed eligible for privatization are being freed from government control and 'let loose on the market' to justify their existence.
- *Private non-profit institutions* encompass a broad range of organizations, ranging from amateur sports clubs to charities such as the Red Cross. Organizations in the latter group are often classified as fund-raising institutions, as they raise money to achieve certain social objectives.

Public sector

Privatization

Organizations in the non-profit sector differ from businesses in a number of respects:

- The objective of a non-profit organization is to achieve certain (socially important) objectives. Its activities are inextricably linked with these goals. The rationale of Médecins sans frontières, for example, is to offer medical assistance in developing countries. This organization is not interested in transferring to other activities out of financial-economic considerations. Furthermore, its donors and supporters would object strongly if the organization switched its attentions to other activities. Conversely, the shareholders of a profit organization such as Unilever would not bat an eyelid if the company decided to stop manufacturing washing powder in favour of another activity that promises higher profit and a higher rate of return.
- Ordinarily, non-profit organizations cannot exist by only conducting market transactions and – in contrast to businesses – are consequently not economically independent. They depend heavily on contributions, donations, subsidies, legacies and so on. To some extent, non-profit organizations are able to operate in the market, for example by selling pre-printed T-shirts.
- Assessing the effectiveness of non-profit institutions is a lot more complex than with businesses. As stated previously, the profit sector uses profit figures to highlight efficiency and effectiveness. Profit figures have no viable place in the non-profit sector.
  A foundation aiding victims is effective only if it succeeds in rectifying the problems of its clients. The degree of success achieved cannot possibly be expressed in financial terms. An alternative method must therefore be found to express the degree of effectiveness of such an organization, for example measuring waiting times or conducting satisfaction surveys among clients for the various services provided. On the other hand, it is usually possible to measure the efficiency of non-profit institutions by calculating the cost per service. A victim-support service, for example, could calculate the cost of an hourly consultation.

The topics and methods discussed in Part 3 (Management Accounting) can therefore also in part be applied to non-profit organizations, as they too strive to operate as efficiently as possible.
Financial reports (discussed in Part 4, Financial Accounting) can also be applied to non-profit organizations, on the strict understanding that profit does not necessary imply that the organization has functioned well, as profit is not the primary goal of the non-profit sector.

YEARS ENDED 31 DECEMBER 2009 AND 2008
ALL AMOUNTS ARE THOUSANDS OF EUROS
This summary shows the total income and expenditure of all Greenpeace offices (including Greenpeace International) worldwide.

Income and Expenditure	2009	2008
Income:		
Other Grants and Donations	195,876	196,620
Interest	1,744	4,583
Merchandising and Licensing	150	(474)
Other Income	2,087	1,834
Total Income	199,857	202,563
Fundraising Expenditure	63,149	60,332
Net Income	136,708	142,231
Expenditure:		
Campaigns:		
• Oceans	7,365	9,479
• Forests	9,340	9,024
• GE	4,737	4,457
• Toxics	3,237	2,855
• Climate & Energy	27,506	22,962
• Peace & Disarmament	178	1,507
• Other Campaigns	2,234	1,225
• Media and Communications	18,870	17,829
• Marine Operations and Action Support	22,046	21,603
• Public Information and Outreach	11,434	9,474
• Political, Science and Business	2,045	1,736
Organizational Support	31,067	30,455
Foreign Exchange (Gain)/Loss	(1,604)	3,355
Loss on Investments	--	5,537
Total Non-Fundraising Expenditure	138,456	141,498
(Deficit)/Surplus for the Year	**(1,748)**	**734**
Opening Fund Balance	**152,882**	**151,193**
Direct Fund Balance Adjustment	**800**	**955**
Closing Fund Balance	151,934	152,882

Source: Greenpeace annual report 2009

TEST QUESTION 1.2
The income of Greenpeace over 2009 was – €1,748,000. Why should we not automatically conclude that 2009 was a bad year for Greenpeace?

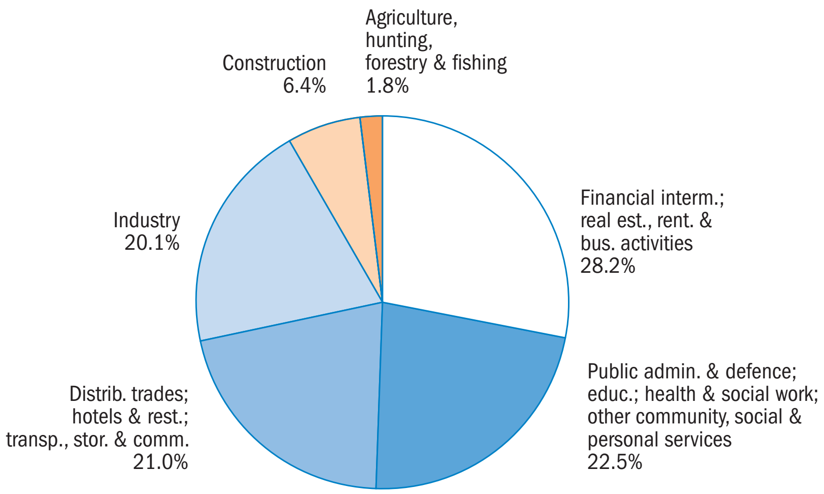
1

1.3 Business activities

In section 1.1, we defined a business as a profit-based production organization. Businesses aim to generate profit by purchasing assets and converting or transforming these assets into goods or services that are sold for more than the original purchase price.

We can roughly classify businesses according to the nature of this 'conversion process':
- agriculture and mining
- manufacturing
- trading
- service.

FIGURE 1.3 Breakdown of value added, EU-27, 2008 (% share of total value added)



Source: *Eurostat Key figures on European business*, 2010 edition

Agriculture and mining

Agricultural and mining companies typically use 'natural' resources. Using relatively few raw materials, they manage to produce large quantities of finished products. For example, the costs of purchasing sowing seed are minimal compared with the proceeds from the sale of the harvest produce. Mining companies extracting minerals such as gold, copper, gas and oil make no use of raw materials at all. Needless to say, fixed assets are vitally important to this sector: the farmer cannot function without farmland, and the extractive industry cannot mine or extract oil without concessions; machinery and heavy equipment are also important.

Manufacturing

Manufacturing businesses create a physical, tangible product, which did not exist in that form prior to the manufacturing process. We can make a distinction between mass production and job production.

Job production

With *job production*, a 'customised' product is produced. Each product is tailored to the specific wishes of the customer. The product is 'made to order': it is first sold and then manufactured. In other words, there is no stock build-up of unsold finished product. A good example of job production is a shipyard, building pleasure yachts to the customer's specifications.

Mass production

Under the *mass production* (also called *flow production*) system, one type of product is manufactured in large quantities. Specific customers' wishes are not taken into account. Products are manufactured for stock. A good example is a sugar refinery.

The differences between job production and mass production are summarized in table 1.1.

TABLE 1.1 Differences between job and mass production

Job production	Mass production
Customized design	Standardized design
Made for one specific customer	Made for the 'market'
Made to order	Made for stock

Batch production

Between the two extremes (job and mass production), we can also identify a 'hybrid', namely *batch production*. Batch production is used to produce or process any product in batches. With batch production, varieties or models of one standard product are manufactured. A yacht builder, for example, could generate considerable cost savings by manufacturing series of hulls, masts and saloons, enabling the customer to design his own 'dream boat' using the available components.

The relevance of each of the three 'inputs' (raw materials, fixed assets and human labour) depends on the type of company.

The costs of an oil refinery comprise mainly raw materials and fixed assets, while a manufacturer of handmade wooden kitchens will predominantly incur labour costs. As automation increases, the importance of fixed assets will increase as a proportion of total costs.

Trading

Trading companies do not manufacture new products. In other words, there is no transformation or conversion process in the technical sense. The *raison d'être* of trading companies is the unequal relation between production and consumption. The inequality can relate to:

1 the scale of production and consumption
2 the composition of production and consumption
3 the point in time that production and consumption take place
4 the place of production and consumption.

EXAMPLE 1.3

A Japanese manufacturer of PCs will struggle to sell his computers directly to French consumers. A computer chain store can purchase computers in bulk in Japan (1), incorporate the products into its range, which is also of interest to the customer (2), hold stock so that the customer can purchase the computer at any time (3) and offer his products to consumers who live in the vicinity of the store (4).

The 'transformation process' of a trading company is therefore a transformation according to size, range, time and place.

Wholesale trading
Retail trading

We can make a distinction between *wholesale trading* and *retail trading*. The retail trader is the last link in the chain; he supplies directly to the end user of the goods, the consumer. Wholesale traders, conversely, purchase from the manufacturer and distribute the purchased products to retail outlets. The wholesale trade is a classic case of business-to-business trading: both the suppliers and the customer are companies. In order to establish an independent function in the production chain, wholesale traders must ensure in particular that the right products reach the stores at the right time. This requires major investment in logistical systems.
The costs of a trading company primarily comprise the purchased merchandise. This type of business also uses fixed assets (business premises, cars, vehicles, etc.). The costs of labour can also be considerable, in particular in the retail trade.

Service

Service companies provide a service to their customers, without manufacturing a new product or transforming an existing product.
This sector can be broken down into a variety of business categories, including:

- financial services (banks, insurance companies)
- hospitality and catering
- haulage
- ICT services (software firms, computer consulting firms)
- general and technical support services (security, catering, cleaning).

Service companies typically make little (or no) use of raw materials. However, fixed assets are vitally important to certain service companies, for example a hotel located in the heart of Brussels, or a shipping company with a fleet of container ships.
Labour is virtually always an important cost item; the service sector is a 'people business': an IT consultancy depends on its IT professionals, a security company depends on its guards.

In container shipping, fixed assets cause large costs. It takes about €150 million to build a large container ship. Labour costs are high as well. By using larger ships, shipping companies try to minimize labour costs. In principle, a large ship does not need more crew than a small ship. So, the labour costs per container are smaller with a large ship. The biggest container ships can carry about 14,000 containers. Due to automation, 13 crew suffices.
The Danish shipping company APM-Maersk controls most of the container shipping market. The company's ships have a joint capacity of more than 2 million containers.

TEST QUESTION 1.3
Below are the cost ratios of three companies:

	1	2	3
Costs of raw materials	15%	48%	0%
Personnel costs	39%	19%	59%
Depreciation costs on fixed assets	5%	4%	3%
Other costs	41%	29%	38%

The three companies are:
- A steel manufacturer
- A manufacturer of hand-painted tiles
- A business consulting firm

Which figures relate to which company?

1.4 Legal forms of businesses

All businesses have a legal form. The choice of legal form determines the legal relationships within the business and between the business and the outside world.

1

The legal form determines the following:
- who has the ultimate say in the business
- what guarantees are in place to ensure the long-term continuance of the business
- in what ways the business can attract funds and financial resources
- to what extent the business owners are liable for the debts incurred by the business
- the tax position of the company
- to what extent the business is obliged to disclose its financial results.

Legal entity

In some legal forms, the business – rather than its owners – is considered the prevailing party in any commercial legal agreement. In these cases, the business is an independent legal entity or 'legal person'.
The business hires staff in its own name, concludes sales contracts and borrows money from the bank. Of course, the business needs people ('natural persons') to conduct these activities on its behalf.
If the business is not the legal person, the agreements will be concluded in the name of the owner/proprietor.

In the next sections, we will discuss the most commonly used legal forms:
Non-legal entity status:
- sole proprietorship
- partnership

Legal entity status:
- joint-stock company.

Sole proprietorship

Equity
Liabilities

In a sole proprietorship there is no separation between the owner and the manager. A sole proprietorship stands and falls with the entrepreneur; if the entrepreneur decides to cease operations, the company disappears with him. In other words, the long-term continuance of the business is uncertain. If the entrepreneur ceases activity or is unable to continue operating, a successor must be found, either in his immediate family or elsewhere.
The business can be financed using funds that the owner is prepared to invest in his company, or through loans. The first finance option is known as *equity*, the second as *liabilities* or *debt*. A sole proprietorship will typically be small, as the available equity will be modest. When starting up his business, the owner will need to invest a percentage of his own money ('private capital') in it; he can strengthen the financial position of his business by retaining profits, i.e. by not using them for private purposes but retaining them in the business.
A sole proprietorship has no legally separate existence from its owner, and legal agreements are concluded in the owner's name. The owner is liable for any debts arising from the operation of his business.

EXAMPLE 1.4

An entrepreneur has invested his savings in a hairdressing business. He borrows the remainder of the required capital from his bank. The business fails to attract enough customers. The entrepreneur is struggling to keep up with his payment obligations (interest and capital). He decides to sell his chairs and equipment, but the proceeds are minimal. In order to repay the bank loan, the entrepreneur is obliged to use private means. If necessary, he may be forced to sell his car or house.

Income tax

The owner of a sole proprietorship pays *income tax* on the profit he makes from the operation of his business.
The regulations on income tax vary per country. Income tax may be a *flat tax*, which means that everyone pays the same percentage of their income to the government. In most countries, however, income tax is a *progressive tax*, in which people with higher incomes pay higher percentages. For example, someone who makes €100,000 per year pays a higher percentage, called a *marginal tax rate*, than someone who makes €30,000. However, it is important to note that the marginal tax rate does not increase for one's entire income, merely for each euro over a certain threshold. Suppose one pays 10% of one's income up to €30,000, and 20% thereafter. Someone making €30,100 does not have to pay 20% on his entire income, merely on the €100 over €30,000. That is, he owes 10% of €30,000 and 20% of the €100 over that.

Progressive tax

Adjusted gross income

Income tax is calculated on the basis of *adjusted gross income*: gross income less allowed personal and business-related deductions such as alimony payments, health-related expenses and pension contributions. In many countries, incentives in the form of additional deductions are offered to encourage entrepreneurship.
Sole proprietorships have no obligations to publicly disclose financial information.

Partnership

In a partnership, two or more people decide to operate a business.
The company is run and managed by the partners. The advantage of a partnership is that both parties can 'invest' their specific expertise, and reach better decisions through mutual consultation. The flip side of the coin is that 'too many cooks may spoil the broth' because of differences of opinion. This may of course have implications for the continuity of the company. On the one hand, the company's continuance need not be jeopardised if either party decides to leave the partnership; on the other, disagreements can result in the premature closure of the business.
Generally speaking, partnerships have more opportunities to acquire equity than sole proprietorships, as a new partner can 'buy into' the partnership.
In a general partnership each partner is, jointly and severally, liable for the debts of the partnership; in other words, a creditor can oblige both partners to repay the debt.

EXAMPLE 1.5

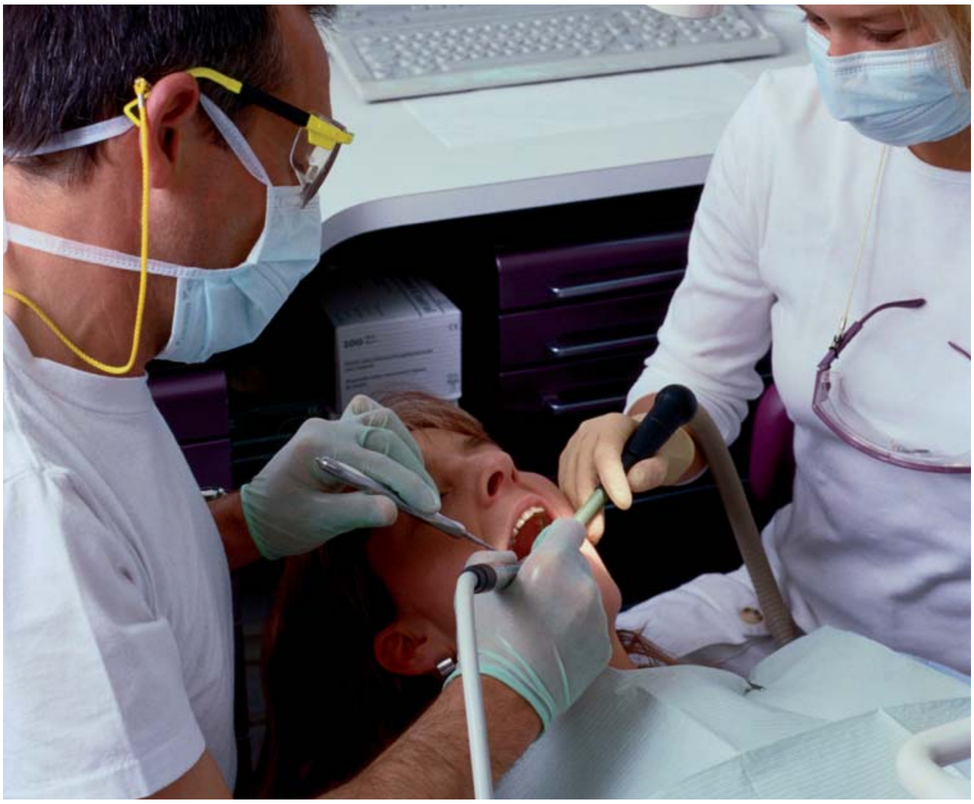
Steptoe and Son trade in antiques and curiosities. Father and son each have a 50% stake in the partnership. The partnership has purchased oriental antiques from an importer for €30,000. The invoice has not yet been paid.
Due to the economic slowdown, Steptoe and Son only manage to sell this stock for €18,000. The partnership has no other assets that can be converted into cash.
The importer is entitled to demand that father Steptoe pay the remaining €12,000. Father Steptoe will now need to find ways to ensure that his son pays him half of the outstanding debt.

Limited partners

1

A partnership can also consist of *limited partners*. In contrast to general partners, limited partners are not obliged to pay the debts of the partnership. Their liability is limited to the amount they invested in the partnership. A person can only be a limited partner on the condition that (s)he does not participate in the management of the partnership; a limited partner is therefore solely a 'financial backer'.

A partnership is transparent for tax purposes: the partners owe income tax on the share of the profit from the partnership.
A partnership is not obliged to publicly disclose financial statements.



The so-called man-and-wife company is a much-used tool to avoid taxes in a progressive income tax system. If an entrepreneur (who first owned a sole-proprietorship business) takes his or her spouse or partner into the company, forming a partnership, each of them receiving 50% of the profits, the total amount payable in income tax is reduced. Both partners are entitled to business-related deductions and (as a result of the progressive taxation system) taxation on one income of, say, €100,000 is higher than on two incomes of €50,000.
The tax authorities do take a critical look at man-and-wife companies. If a dentist takes his wife – who acts as his assistant – into the company, they will argue that such a company is 'uncommon'. After all, the company depends on the work of the dentist; it is he who decides on policy. In view of the imbalance in the work, the authorities will not recognize this type of man-and-wife company as a partnership.

Joint-stock companies

Joint-stock companies are legal entities; as we have seen earlier, they can conclude agreements in their own name.
We can identify two types of joint-stock company: the limited liability company (LLC or Ltd) and the public limited company (PLC). We shall discuss the shared characteristics of the two business forms, before focussing on the differences.

LLC
PLC

The equity of joint-stock companies is divided into *shares*. The shareholders are the owners of the joint-stock company. A board of directors is responsible for the day-to-day running of the business.
A joint-stock company can increase its equity if the meeting of shareholders decides not to pay out any profits, but to retain the profit. It may also decide to issue shares.
This type of business tends to be more secure than the sole proprietorship and partnership, as 'management' and 'ownership' are separated.
Shareholders are not personally liable for repaying the debts of the joint-stock company; their risk is limited to the value of their share holdings.

Shares

The fiscal position of the joint-stock company is rather complicated as there are two taxes involved.
Joint-stock companies are liable for corporate tax on their profits.
The shareholders, in turn, pay income tax on the dividends they receive following profit distribution.
Individual countries use different systems with regard to the levying of corporate tax and income tax on shareholders.
There are two main systems: the classical tax system and the imputation tax system.
The *classical system* of corporation tax is a system of taxing companies in which the company is treated as a taxable entity separate from its shareholders. The profits of companies under this system are therefore taxed twice: first when made by the company and again when distributed to the shareholders as dividends.

Classical system

Under an *imputation system*, taxes paid by a corporation are considered as paid on behalf of its shareholders. The tax paid by the corporation is credited against the tax liability of the shareholder. Thus, imputation systems eliminate re-taxation of the distributed profits of a corporation.
We shall illustrate these systems in example 1.6.

Imputation system

EXAMPLE 1.6

Joint-stock company A has recorded a profit of €1,000,000. All profit after taxation is paid out to its shareholders. The rate of corporate tax is 25%, and income tax is 50%.

Classical tax system
Under this system, corporate tax and income tax are levied separately.
€250,000 in tax is levied on joint-stock company A; the profit after taxation is €750,000.
This is paid out as dividends; in total, €375,000 income tax is levied on the shareholders.
The total tax burden on the profit is therefore:

(€250,000 + €375,000)/€1,000,000 = 62.5%.

1

Imputation tax system
Under this system, tax is levied once only on the profit. Although €250,000 tax is levied on joint-stock company A, this is not a separate levy, but a prepayment against the income tax to be paid by the shareholder.
€1,000,000 is attributed to the shareholders as dividends. A total of €500,000 income tax is levied. However, the corporate tax of €250,000 can be set off against income tax, so that the total income tax bill for the shareholders is €500,000 less €250,000 = €250,000. In effect, shareholders are credited for the tax suffered by the company on its income.
Under this system, the total tax burden is 50%, namely the income tax.

Within the EU, the imputation system is used in most countries. The Netherlands uses the classical system.
The following should be noted with regard to taxation:
- Most countries try to strike a 'tax burden balance' between companies that are not run as legal entities and those that are. This harmonization is achieved 'automatically' under the imputation system.
- We can also identify a third type of tax levied on joint-stock companies: dividend taxation. This does not increase the tax burden, as it is treated as an 'advance levy' in respect of income tax. In other words, the sharehol-ders can offset any dividend tax against their income tax.

CORPORATE TAX RATES IN WESTERN EUROPE (2009)

Belgium	33.99
Denmark	25
France	33
Germany	15
Greece	20/25
Ireland	12.5/25
Italy	3.9/27.5
Luxembourg	21
Netherlands	20/23/25.5
Norway	28
Portugal	20/25
Spain	30
Sweden	26.3
Switzerland	8.5
United Kingdom	28

Joint-stock companies are required by law to publish an annual report, the main components of which are the financial statements: the balance sheet and the profit and loss account.

Differences between limited liability companies and public limited companies

In general – legislation differs from country to country – public limited companies (PLCs) tend to be companies that trade their shares on the stock exchange. The shares can be traded on a daily basis and the market price is continually known. The articles of incorporation thus pose no restrictions on the transfer of shares from one shareholder to another. PLCs must also satisfy the statutory minimum share capital requirements.
Limited liability companies (LLCs), conversely, may have only one shareholder, usually the managing director. Sole proprietors often decide to become a limited liability company due to the tax advantages and the liability aspect.
The list below gives the names of LLCs and PLCs in various countries:

	LLC	PLC
Netherlands	Besloten vennootschap met beperkte aansprakelijkheid (BV)	Naamloze vennootschap (NV)
Germany	Gesellschaft mit beschränkter Haftung (GmbH)	Aktiengesellschaft (AG)
France	Société à responsabilité limitée (SARL)	Société anonyme (SA)
Spain	Sociedad Limitada (S.L.)	Sociedad Anónima (S.A.)
Italy	Societa a responsabilita limitata (Srl)	Societa per Azioni (SpA)
Denmark	Anpartsselskab (ApS)	Aktieselskab (A/S)
USA	Limited liability Company (LLC or Co. Ltd)	Corporation (Corp.) or Incorporated (Inc.)
Japan	Godo kaisha (G.K.)	Kabushiki kaisha (K.K.)

1.5 Value added tax

In section 1.4 – where legal forms of business were discussed – taxes that are levied on the profit a company has made were also discussed. For non-legal entities income tax is applicable and for legal entities corporate tax applies.
In this section we discuss value added tax (VAT), a tax that every business in Europe and in most other countries in the world – regardless of its legal form – is confronted with. *Value added tax* is a tax that is levied on consumer spending. The final buyer of a commodity or a service has to 'foot this tax bill'. **VAT**
In order to achieve this, a system of taxation on added value is applied. Each time a company makes a sale, it has to increase the selling price with value added tax, which the company has to pay to the tax authorities. Every country in the EU has its own percentage(s) of VAT and these percentages may be changed from time to time.

The tax is payable irrespective of whether the buyer is a consumer or another company. When the buyer is a company, he is entitled to reclaim from the tax authorities the VAT that was passed on to him. When the buyer is the final consumer, he does not have this right of reclamation and he is 'stuck' with the tax.

Sales tax

Outside Europe a *sales tax* is sometimes levied instead of VAT. For example, this is the case in the US. Sales tax differs from VAT in that it is levied only at the final sale to a consumer, not at earlier stages in the trading process. For the consumer this does not make much difference. In the end he has to pay the tax. The biggest difference is obviously for companies that do not sell to consumers. They don't have to bother with sales tax.

EXAMPLE 1.7

Company X extracts raw material and uses it to manufacture a product. The total costs of the product are €100 per unit. Company X sells the product to a wholesale trader for €150 per unit. The wholesale trader sells the product to a retailer at a price of €170 per unit and in turn the retailer sells the product to consumers at a price of €200 per unit.
The percentage of VAT is 19%.

When company X sells one product to the wholesale trader VAT at 19% of €150 has to be paid. The selling price including VAT is therefore 1.19 × €150 = €178.50. Company X pays 19% × €150 = €28.50 to the tax authorities.

The selling price of the wholesale trader is €170. At the sale of the product by the wholesale trader to the retailer the selling price including VAT amounts to 1.19 × €170 = €202.30. The wholesale trader owes the tax authorities the difference between the received VAT and the paid VAT per unit: €32.30 – €28.50 = €3.80.

The selling price of the retailer is €200. Including VAT the selling price is 1.19 × €200 = €238. The retailer has to pay €38 – €32.30 = €5.70 to the tax authorities.

Table 1.2 summarizes the above:

TABLE 1.2 Consequences of VAT for businesses

	Selling price including VAT	VAT to be paid	VAT to be received	Net price	Profit
Manufacturer					
Cost of goods sold	€100			€100	
Selling price	€178.50	€28.50		€150	€50
Wholesale trader					
Purchase price	€178.50		€28.50	€150	
Selling price	€202.30	€32.30		€170	€20
Retailer					
Purchase price	€202.30		€32.30	€170	
Selling price	€238	€38		€200	€30
Consumer					
Purchase price	€238			€238	

Table 1.2 shows the following:
- VAT does not raise costs for a company. VAT owed to the tax authorities is transferred to the buyer and VAT paid to suppliers is reclaimed from the tax authorities.
- In the presentation of the profit and loss account, VAT plays no part. Revenue and costs are presented excluding VAT.
- In the end the consumer pays all levied VAT on products and services. VAT is a consumer tax.

TEST QUESTION 1.4
Under what circumstances will a negative VAT balance cause the company to receive VAT from the tax authorities?

Special situations
- Reduced rate
  A reduced rate of VAT is levied on the sale of some goods and services, including some food products, medicines, and theatre and sports tickets.

- Exemptions
  A number of goods and services are exempt from VAT, including educational, medical and cultural services. Organizations in these lines of business face two consequences:
  1. They do not need to raise the selling price with VAT and therefore do not pay VAT to the tax authorities.
  2. They cannot reclaim paid VAT to suppliers.

EXAMPLE 1.8
A company called Living specializes in organizing cultural events. In April a customer is charged €500 and Living receives a bill for €1,500 plus €285 VAT for repairs to its building.
Cultural services are exempted from VAT, so Living does not have to include VAT in its selling prices. The customer just pays the net amount of €500. Living cannot reclaim the VAT amount of €285 it paid to its supplier.

- Export
  Value added tax is a consumption tax and is therefore levied in the country where the customer lives. So, sales of services to other businesses or private customers are charged VAT where the customer is based, not where the supplier is established.

EXAMPLE 1.9
Dutch trading company ‘Golden Oak’ buys wooden furniture from Dutch manufacturers and exports them to Germany. Golden Oak buys furniture at €10,000 plus €1,900 VAT.
A German customer is charged €10,000.
Golden Oak can reclaim the paid €1,900 VAT from the Dutch tax authorities. The delivery of goods to the German customer is charged a net selling price excluding VAT. The German customer has to pay VAT to the German tax authorities.

1.6 Forms of association between businesses

To a greater or lesser degree, businesses may wish to establish some form of collaboration with other businesses. In return, they relinquish (part of) their independence. Their competitors have effectively turned into colleagues. We will discuss three types of association: mergers and takeovers, franchising, and cartels.

Mergers and takeovers

Any business that wants to grow will need to engage in new activities. However, sometimes it is easier to accomplish growth by absorbing another company than by growing on one's own (autonomous growth). A *takeover* or *acquisition* is typically achieved by acquiring a controlling interest in the target company, by purchasing the majority of its shares. A *merger* is the combination of two companies in order to gain mutual benefits. In this case there is no acquirer and no target, but two equal partners.
The relationship between the involved companies in a merger or takeover can differ. We will illustrate this by means of the company's position in the production process.

We can identify the following types of merger or takeover:

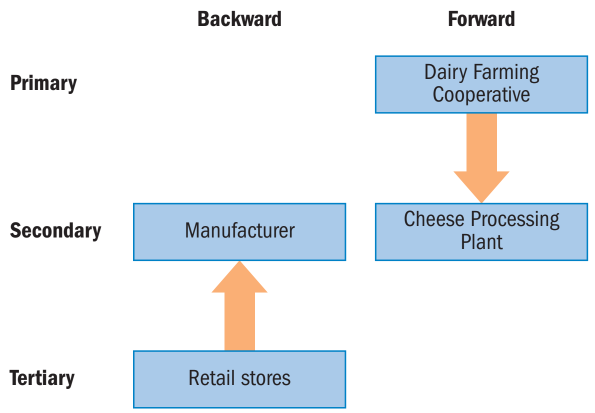
Industry

1 The businesses operate in the same industry. An *industry* is a division of a market sector and includes companies producing the same or similar goods and services. These companies often compete with each other for customers. When one chain of petrol stations acquires another chain, competition is reduced and cost savings may be realized, e.g. by obtaining larger discounts on the purchase of oil products.

Vertical integration

2 The businesses operate at different stages of the production process. This is called *vertical integration*. When a chain of retail stores acquires the manufacturer of its products, this is called backward vertical integration: acquisition takes place towards the source. A dairy farm cooperative acquiring a cheese-processing plant is an example of forward vertical integration. See figure 1.4.

FIGURE 1.4 Vertical integration



In the oil business the big five oil companies (BP, Chevron, ConocoPhillips, ExxonMobil and Shell) control all stages of the production process, from nodding donkey to gas station.

3 Acquirer and target operate at the same stage of the production process but in different industries, e.g. a confectionery manufacturer taking over a soft drinks manufacturer. This is called *horizontal integration*.

4 Acquirer and target operate in different lines of business. This is called *conglomerate acquisition*. In the past, many conglomerate companies were formed, operating at different stages in different industries. The objective of these companies was risk reduction. Nowadays, such conglomerate businesses are no longer popular, because they turned out to be very hard to control by one centralized management. The present trend is to go back to core business: companies focus on core activities and sell non-corresponding departments.

Horizontal integration
Conglomerate acquisition

Franchising

Under the franchising formula, a sole proprietor affiliates with a chain and is granted access to certain facilities such as the company name, purchasing system, marketing operation and store design and layout services.
For the franchiser, it is particularly important that the sole proprietor knows the local market well. The franchisee, meanwhile, remains a sole proprietor, although 'the outside world' perceives the franchisee as a branch manager. The franchisee pays a fee – usually in the form of a percentage of sales – to the franchiser for the facilities placed at his disposal.

1

In 1940 the brothers Dick and Mac McDonald opened McDonald's Bar-b-que restaurant on Fourteenth and E streets in San Bernardino, California. After WWII the introduction of the Speedee Service System established the principles of the modern McDonald's formula. Ray Kroc, a milkshake machine representative, advised the brothers to open more restaurants. Today, McDonald's operates more than 31,000 restaurants worldwide. Each restaurant is run by a private owner under a franchising formula. If you want to own a McDonald's you will need private savings of at least €250,000. In exchange, you can use the McDonald's name, logo and recipes. You will have to pay a percentage of your sales revenue to McDonald's.

Cartelization

Under cartelization, independent companies draw up agreements that are designed to restrict competition. The opportunity to make such agreements is dependent on the market in which the businesses operate.

Competitive market
Monopoly

In a *competitive market*, there are a multitude of companies offering a standardized product to a multitude of customers. This is an intensely competitive environment. At the other extreme is the *monopoly*: there is only one market player, and no competition.
Neither of these market forms provides an ideal basis for cartelization.

Oligopoly

An *oligopoly* is defined as a market dominated by a few large suppliers. A good example is the road construction industry. In an oligopoly, businesses can be tempted to make agreements on selling prices. They may even go as far as to 'distribute the market amongst themselves'. This is a classic case of cartelization. As cartelization tends to disadvantage consumers, the European Union has identified the counteracting of any cartelization tendencies as a key priority.

TEST QUESTION 1.5

Name two examples of sectors in which an oligopoly applies.

Glossary

1

Business	An economic unit that aims to sell goods and services to customers at prices that will provide an adequate return to its owners.
Cartel	An agreement between businesses that is designed to restrict competition.
Classical tax system	Tax system in which corporate tax and income tax are levied separately.
Economics	Discipline concerned with man's search for prosperity; i.e. acquiring goods and services as cheaply as possible.
Effectiveness of the production process	Manufacturing goods or services that are demanded and appreciated by customers.
Efficiency of the production process	Manufacturing a certain good or service with the least possible costs.
Franchising	A sole proprietor affiliates with a chain and is granted access to certain facilities by paying a fee.
Imputation tax system	Tax system in which corporate tax is treated as a prepayment for income tax.
Job production	Products are tailored to the specific wishes of the customer.
Joint-stock company	Legal entity in which equity is dividend in shares; can be either a limited liability company or a public limited company.
Limited partner	Partner in a partnership who is not liable for the debts of the partnership; (s)he is not allowed to participate in the management.
Mass production	A product is manufactured in large quantities, without taking into account any specific customers' wishes.
Mission statement	Summary of the aims and objectives of an organization.
Organization	Alliance between people and resources aimed at achieving certain aims and objectives.

Partnership	Non-legal entity in which the partners are owners as well as managers.
Production	Manufacturing goods and services that satisfy human needs.
Retail trader	Supplies directly to the end user of the goods.
Sole proprietorship	Non-legal entity in which one person is owner as well as manager.
Takeover	The purchasing of the majority of the shares of another company.
Value added tax	A tax levied at each stage in the production of a good or service that results in value being added to the product.
Wholesale trader	Purchases from the manufacturer and sells to the retailer.

Multiple-choice questions

1.1 Which of the following organizations is not a business?
a a record store
b a university hospital
c a shipping company
d a tax consultancy firm

1.2 Which of the following activities is not concerned with efficiency?
a purchasing from a selected group of suppliers to achieve bigger discounts
b modifying a product to shorten processing times
c sending sales invoices more quickly
d modifying a product to tailor it to customer wishes

1.3 Which of the following statements is correct?
a Companies tend to find it more difficult to transfer to other activities than non-profit organizations.
b Non-profit organizations are economically independent, because they rely on contributions, donations, subsidies, legacies and so forth.
c Extending discounts to reliable customers is a business tactic that can secure maximum profit.
d The supply of public-sector goods is regulated through the market mechanism.

1.4 Which of the following statements is incorrect?
a It is more difficult to measure the effectiveness of profit-based businesses than non-profit institutions.
b Non-profit institutions always strive to operate as efficiently as possible.
c Public-sector goods and services are provided by the government, because market mechanisms are not suitable for these goods and services.
d A negative financial result for a non-profit organization does not necessarily imply that the organization has performed poorly.

1.5 Which of the following types of information is *not* likely to be included in a mission statement?
a the environmental credentials of the business
b the main product groups offered by the business
c the groups of participants for which the business wants to improve the level of prosperity
d the expected profit for next year

1.6 Which of the following statements is incorrect?
- **a** A service business purchases hardly any raw materials.
- **b** With mass production products are usually manufactured for stock and not to order.
- **c** The production process of a trading company can be a conversion according to place.
- **d** Service businesses tend to have relatively low labour costs.

1.7 The manufacturing of a car in a saloon and a cabriolet version is called:
- **a** job production
- **b** batch production
- **c** mass production

1.8 Statement 1: The wholesale trade is 'business to business.'
Statement 2: Wholesale trade in seasonal products is important for reducing the time between production and consumption.
- **a** Both statements are correct.
- **b** Statement 1 is correct, statement 2 is incorrect.
- **c** Statement 1 is incorrect, statement 2 is correct.
- **d** Both statements are incorrect.

1.9 Which of the following businesses is not obliged to publish financial statements?
- **a** Johnson Ltd
- **b** Harvey PLC
- **c** Eastman LLC
- **d** Brown & son partnership

1.10 The Torville & Dean partnership has failed to repay a bank loan of €100,000. Torville has a 40% share, Dean a 60% share in the partnership.
The bank is entitled to demand that Torville pays:
- **a** nothing
- **b** €40,000
- **c** €50,000
- **d** €100,000

1.11 A partnership has two general partners and one limited partner. General partner A has invested €100,000 in the partnership, general partner B €50,000 and limited partner C €450,000. The partnership has a total debt of €1 million. Partner A is liable for:
- **a** €100,000
- **b** €500,000
- **c** €550,000
- **d** €1 million

1.12 Which of the following statements is incorrect?
- **a** A sole proprietorship is subject to corporate tax.
- **b** Under the imputation system, corporate tax is treated as a prepayment of income tax levied on the shareholders.
- **c** The 'company tax burden balance' aims at striking a balance between companies that are legal entities and those that are not.
- **d** The partners in a partnership are subject to income tax.

1.13 XYZ Ltd records a profit of €400,000 and distributes half of its profit after taxation to shareholders. The rate of corporate tax is 20% and the rate of income tax is 45%.
Under the classical system, the total amount in taxes paid is:
a €72,000
b €80,000
c €152,000
d €224,000

1.14 Which of the following statements is incorrect?
a LLCs and PLCs are both joint-stock companies.
b Shareholders are not liable for the repayment of a company's debts.
c A limited partner in a partnership is liable for the partnership's debts.
d Only public limited companies can have their shares traded at the stock exchange.

1.15 A Dutch wholesale trader purchases 1,000 radios at a unit price of €20 excluding 19% VAT. The trader sells 700 radios to Dutch retailers at a selling price of €30 excluding 19% VAT and 300 radios to a Belgian wholesaler at a selling price of €40.
The Dutch wholesale trader pays the Dutch tax authorities an amount of:
a €190
b €2,470
c €3,520
d €4,210

1.16 An industry comprises:
a businesses operating at the same stage of the production process
b businesses operating at all stages of the production process of a single product
c businesses operating in the same market sector
d competing businesses.

1.17 The owner of a do-it-yourself shop affiliates with a chain, thereby being allowed to call his shop Hobby Plus.
The owner pays a fee on the basis of his turnover. This is:
a franchising
b a merger
c a takeover
d cartelization

1.18 When businesses enter into a cartel agreement, their aim is:
a to start a new joint-stock company
b to buy out competitors
c to have a stronger bargaining position with regard to the trade unions
d to restrict competition

1.19 Cartelization will predominantly occur in a:
a monopoly
b oligopoly
c competitive market
d all of the above mentioned