The Basics of Financial Management

Noordhoff

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5th edition

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Preface to the fifth edition

The Basics of Financial Management offers a complete introduction to the field and can be used for first-year students in higher economic education programs, as well as a basic course in non-economic programs.
Part 1 of the book is an introduction to business economics, which introduces students to how companies function and key financial-economic concepts. Parts 2, 3, and 4 cover the fields of finance, management accounting, and financial accounting. These parts can be studied in any order.

To increase user friendliness, we have divided the material into smaller units of study in this fifth edition. There are now more chapters and more paragraphs per chapter. This has also led to improvements in the order of the topics.

The material on legal forms of companies, including profit tax and income tax, is now included in a separate chapter. Associations and foundations have been added as legal forms of non-profit organizations.
The material that was covered in the chapter on *budgeting* is now divided into two chapters, the first discusses the feed-forward function of budgeting and the second the feed-back function. As new material, the latter chapter includes the topic of *sales variance*.
The annual report is now discussed in separate chapters covering the balance sheet and the income statement. In the latter, the difference between categorical and functional income statements is discussed in more detail.
All material has been updated.
The multiple-choice questions at the end of each chapter are broken down in paragraphs.

In the corresponding exercises book, the exercises are arranged per paragraph and divided into three types: *knowledge questions* that test whether the student has mastered the theoretical concepts, *exercises* and *insight questions*. The explanations of the exercises are included in the answers and solutions book.

Additional practice materials are included on the website
www.basicsfinancialmanagement.noordhoff.nl

Many generations of students have acquired their elementary business knowledge with the help of this book in recent years. In designing this new edition, today's students are hopefully just as enthusiastic about its content and didactics.

Any comments or suggestions are, as always, very welcome.

The authors

Series overview

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

Contents

Introduction

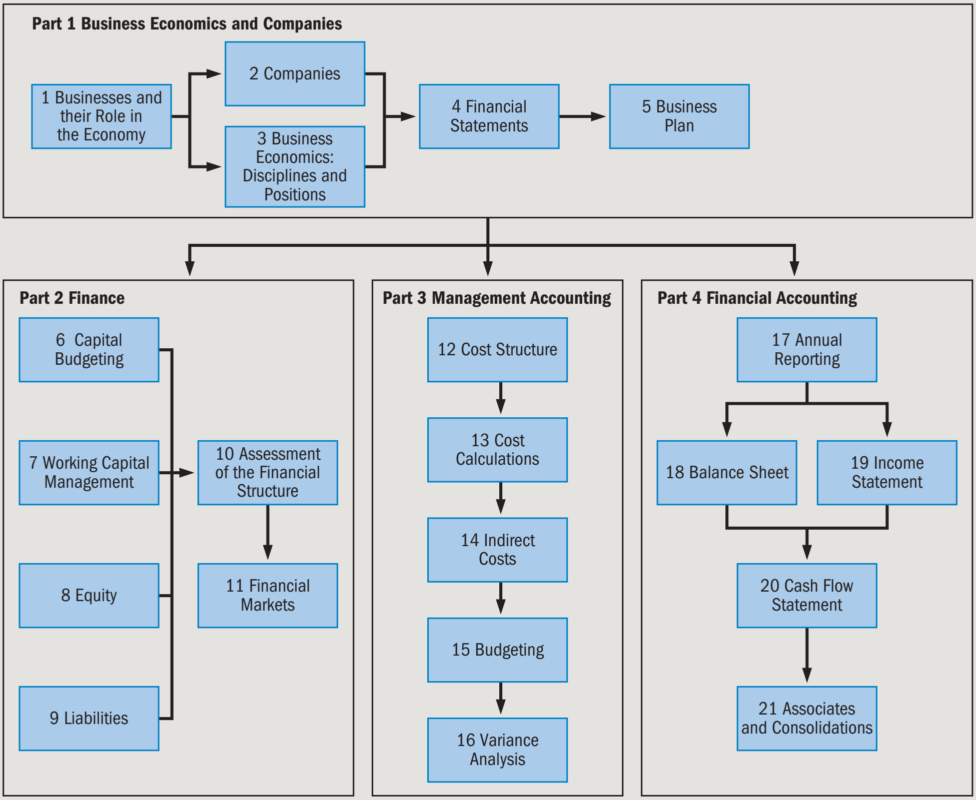
The Basics of Financial Management can be used to give (future) professionals with a non-specific financial function insight into business economics, at such a level that they can function as a fully-fledged discussion partner of financial specialists. In addition, this book is intended for students in financial-economic studies as a basic training in preparation for further in-depth studies.

To increase the user-friendliness of the book, we will provide some explanations about its structure and possible use.

The book consists of four parts: *1 Business Economics and Companies*, *2 Finance*, *3 Management Accounting* and *4 Financial Accounting*. The first part provides insight into some basic concepts of business economics. It is recommended to start with this part. Armed with this knowledge, the next three parts can then be studied independently.
To support students who just want to study one specific topic, because they study problem-based learning or project-based learning for example, the diagram on the next page shows the interrelationships between the chapters in the book.

For each chapter, this diagram is repeated, again explicitly showing the direct relationship to the other chapters. This allows the student to quickly see if prior knowledge of other chapters is needed before starting a particular topic.
The book also includes an extensive table of contents and an index to help you find searched topics quickly.

In presenting the material, we used the premise that the student should be able to master the theory independently.
For the purpose of self-study, many examples are used. By means of tests, students can check whether they understood the material that was discussed. The answers to these tests are included at the end of the book, so that students can immediately check if their answers were correct. To illustrate the practical relevance of the theory, we have included explanatory texts with photos, newspaper clippings and fragments of annual reports. Important concepts are emphasized by including them in the margins.
Each chapter ends with a list of key terms and multiple-choice questions. The answers to the multiple-choice questions are included in the back of the book.



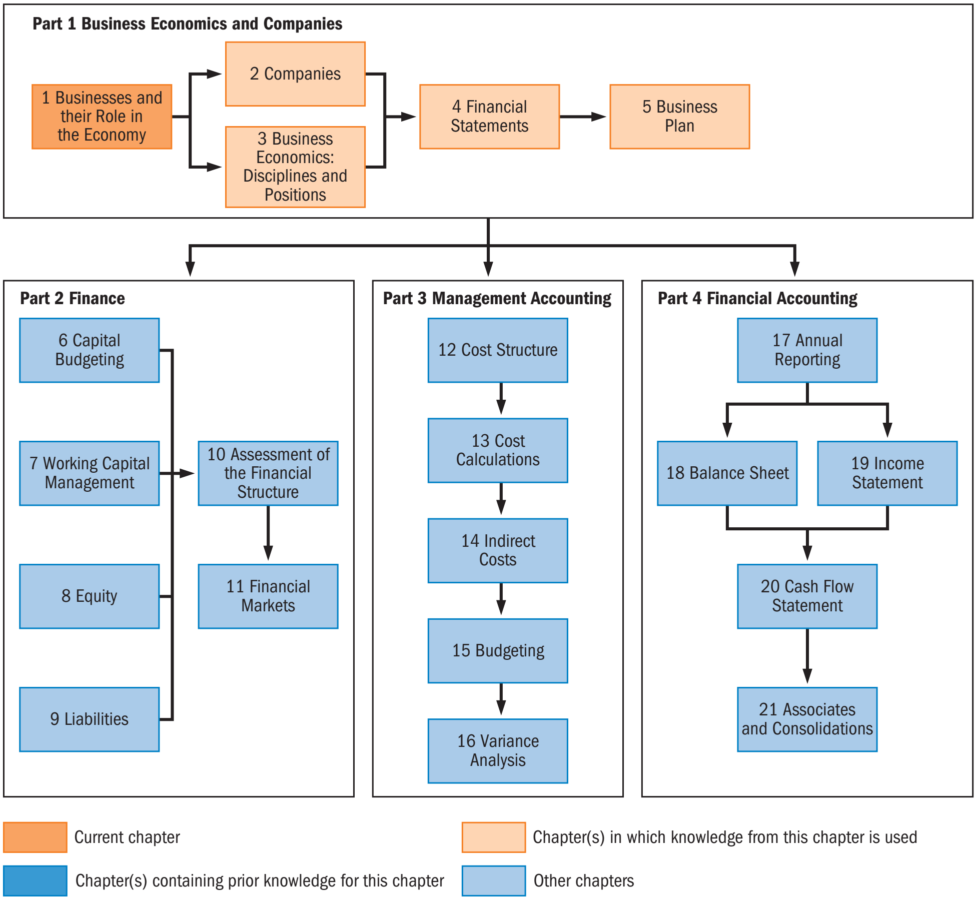
The theory can be tested with the help of the *Exercises* book. For a number of exercises, extra practice material with Excel variants is available on the website. The exercises are categorized according to degree of difficulty. The exercises are elaborated in the *Answers and Solutions* book.

Flexible learning routes
Based on the above, several main learning routes can be distinguished for studying the entire subject matter in this book. The first route follows the structure of the book, starting with the *Finance* section, followed by the *Management Accounting section* and finally the *Financial Accounting section*. The authors prefer this order, which is line with the successive challenges that a starting entrepreneur is faced with.

In the second main route, the *Management Accounting* section is studied first, followed by the *Finance* and *Financial Accounting* sections. This sequence is more in line with the traditional approach to the field, which starts with cost accounting issues.

It is also possible to immediately start with the *Financial Accounting* section after the introductory part. This is an unusual route for the entire study of the subject matter. However, the structure of the method allows for this.

PART 1
Business Economics and Companies


Part 1 Business Economics and Companies
1 Businesses and their Role in the Economy
2 Companies
3 Business Economics: Disciplines and Positions
4 Financial Statements
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6 Capital Budgeting
7 Working Capital Management
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Part 4 Financial Accounting
17 Annual Reporting
18 Balance Sheet
19 Income Statement
20 Cash Flow Statement
21 Associates and Consolidations
Current chapter
Chapter(s) in which knowledge from this chapter is used
Chapter(s) containing prior knowledge for this chapter
Other chapters

1 Businesses and their Role in the Economy

No pre-knowledge required

Learning objectives
Gain insight into:
- the sub-sections of economics (1.1)
- the object of study of business economics (1.1)
- the characteristics of companies (1.2)
- the significance of efficiency and effectiveness for a company's pursuit of profit (1.2)
- the characteristics of non-profit organizations (1.3)
- the classification of businesses into four main sectors (1.4)
- the characteristics of businesses in each of the four main sectors (1.4)
- the different forms of cooperation in and between supply chains (1.5)
- the characteristics of merger/takeover, joint venture, franchising and cartel (1.6)

Chapter 2 focuses on different forms of companies, especially the difference between companies with or without a legal entity. We also pay attention to the fiscal aspects of entrepreneurship.
Chapter 3 divides business economics into three main areas: *finance*, *management accounting* and *financial accounting*. The connection with other disciplines is also discussed, as well as the most relevant positions for someone with business economics knowledge.
Chapter 4 zooms in on the most important financial statements of a company. The balance sheet provides an overview of both the value of the assets in which the company has invested, as well as the way in which

these assets have been financed. The difference between profit and the change in cash is also discussed in this chapter. Profit is the difference between sales revenue and costs, and the change in cash is the difference between cash-inflow and cash-outflow.
Chapter 5 is about drawing up a business plan, in which financial statements play a crucial role.

1.1 Economics and Business Economics

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, produce goods and services and sell these to consumers at a certain price. Consumers obtain purchasing power from the income generated by working for these companies.

Economics

Economics 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?

General economics

Microeconomics

General 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 the theory behind markets for example. How does 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 Section 1.6.

Macroeconomics

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

Business economics

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.
The economic system assigns an important role to production. Companies are production organizations focused on earning income for their owners 'on the market': they are production organizations in pursuit of profit.

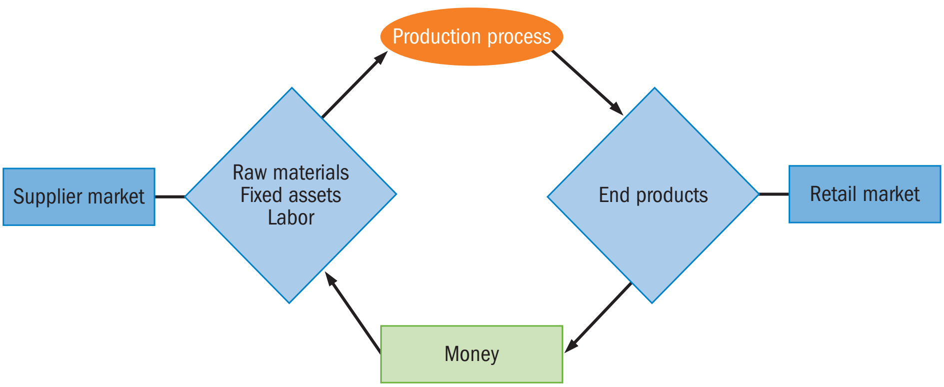
TEST QUESTION 1.1

Explain why every business is a company, but not every company is a business.

1.2 Characteristics of Companies

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 because these assets remain in service of the company for extended periods of time, compared to raw materials. 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



The Coca-Cola company uses raw materials for the production of Coca-Cola. Coca-Cola contains 89% carbonated water - water, carbon dioxide, sodium -, sugar, caramel, phosphoric acid, caffeine and a mixture of coca leaf, fruit extracts, vanilla and spices. The exact blend of plant extracts is still the best-known secret formula in the world today.
In addition to the raw materials, Coca-Cola should of course also use sustainable means of production, such as bottling plants, distribution centers, transport lorries, computers and many other means of production. Employees are an indispensable link in the chain.

Capital

The raw materials and fixed assets are referred to as the organization's capital. The production organization is therefore a cooperation between the production factors labor and capital.
This cooperation may have a formal character, in which the rights and obligations of the participants involved in the organization are laid down in writing: the powers of shareholders, management and employees are written down in the articles of association and in task descriptions.
A production organization can also consist of two students that set up a courier service together, the only agreement being that one alternately sits by the telephone and the other is riding the scooter.

TEST QUESTION 1.2
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. Can you name some other participants?

A company seeks to maximize its profit
A company participates in the economic process with the intention that its owners will be '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 section describes businesses without a profit target.

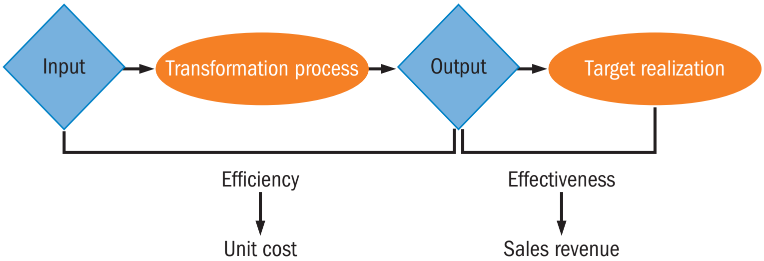
Efficiency
Effectiveness

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 1.1
Coca-Cola will strive to produce its product with the most economical use of labor and capital goods. Based on given quality standards, it will try to keep the cost per unit as low as possible. The cost per unit is therefore a measure of efficiency.
The end product has to be of such quality that it can acquire and retain a market share in the soft drinks market. The taste of the coca cola, the price/quality ratio and the positioning through advertising has to contribute to this. The extent to which Coca-Cola succeeds in generating sales revenue indicates its effectiveness.

Figure 1.2 shows the role of efficiency and effectiveness in the production process.

FIGURE 1.2 Efficiency and effectiveness in the production process



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).

Profit
Sales revenue
Turnover
Costs

TEST QUESTION 1.3
A company that has set up an extremely efficient production process is not automatically successful. How is that possible?

Realizing 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.

A telling example of this is Royal Philips nv. Starting as a light-bulb factory in 1891, it added all kinds of other products: household appliances such as shavers, electric toothbrushes, coffee machines and consumer electronics such as TVs and stereos.
Today, Philips is fully dedicated to the development and production of healthcare technologies. The light bulb factory has been divested. Other products still offered under the Philips brand are in fact produced by other companies.

1

Profit is the target, the activities are a means to an end.

However, the following should also be kept in mind:

Continuity

- Maximizing profit 'at all cost' is usually not considered the highest priority; the *continuity* of the company is also an important concern. Profit is necessary to guarantee 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 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 that a major company's target is optimizing sales revenue instead of optimizing profit. Corporate managers often appear to feel that bigger is better. E.g. 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.

Mission statement

- Companies generally present a *mission statement* that outlines their targets without addressing their drive for profit as a prominent factor. Instead, they focus on environmental issues, employee job satisfaction, etc. Below you will find examples of some major companies.

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.

Coca-Cola
To refresh the world...
To inspire moments of optimism and happiness...
To create value and make a difference.

Shell
Shell's purpose is to power progress together with more and cleaner energy solutions. We believe that rising standards of living for a growing global population are likely to continue to drive demand for energy, including oil and gas, for years to come. At the same time, technology changes and the need to tackle climate change means there is a transition underway to a lower-carbon, multisource energy system.

1.3 Characteristics of Non-Profit Organizations

Companies focus on maximizing profit and are part of the profit sector. This book pays particular attention to that sector. However, there are also many non-profit organizations. A distinction can be made between public and private non-profit organizations.

Public sector

- 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 and services. The government imposes compulsory contributions (tax) and provides a budget to finance the production of public goods.

Market mechanism

Budget mechanism

There are also general facilities that have been offered by the government in the past to influence their availability to a larger public but 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.

Privatizing

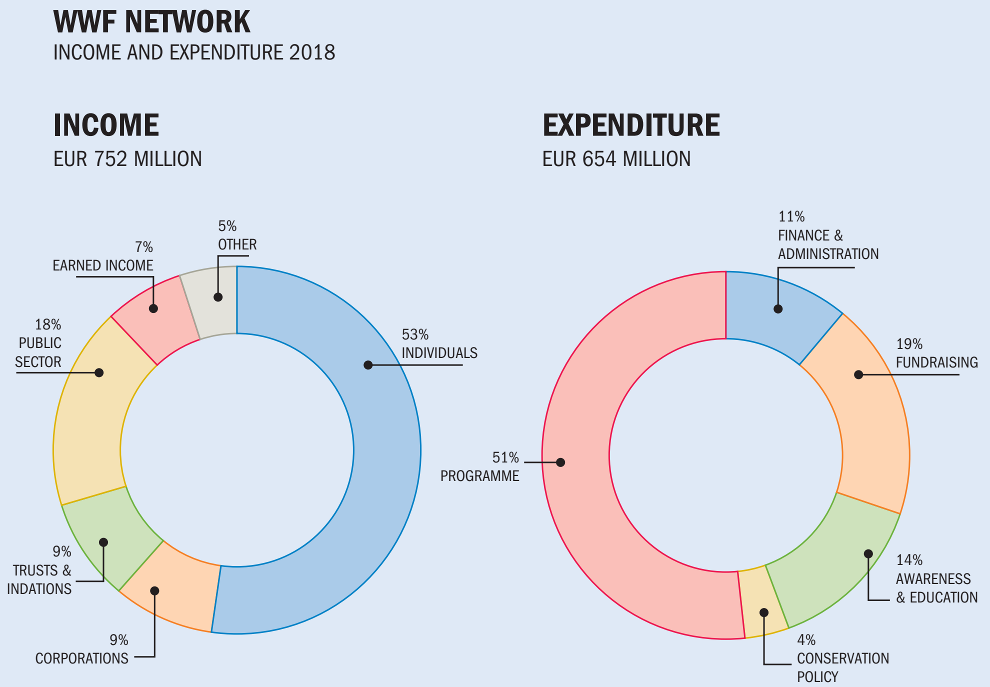
- *Private non-profit businesses* comprise a wide variety of organizations from amateur sports clubs to charitable organizations such as the Red Cross. The latter is also known as a fund-raising institution as it attempts to raise funds to achieve a worthy social objective.

Differences with companies
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 organizes 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 any sleep over the fact that 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 by selling T-shirts with a logo for example.
- The assessment of the effectiveness of non-profit organizations is much more difficult than that of a company. As established earlier, 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 organizations can monitor their efficiency by calculating their costs. For example, a foundation for victim aid could calculate the costs of one-hour consultations.

The topics discussed in this book are mainly applicable to companies, although they are also relevant for non-profit organizations. This applies in particular to the topics in the section on Management Accounting, as non-profit organizations should also attempt to work as efficiently as possible.

In the section on Finance, a number of the financial resources only available to companies are discussed, such as shares. Other topics 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 AND EXPENSES WORLD WILDLIFE FUND IN 2018



Source: http://www.panda.org

TEST QUESTION 1.4
Can you conclude from the figures presented whether the WWF has done well?

1.4 Business Activities

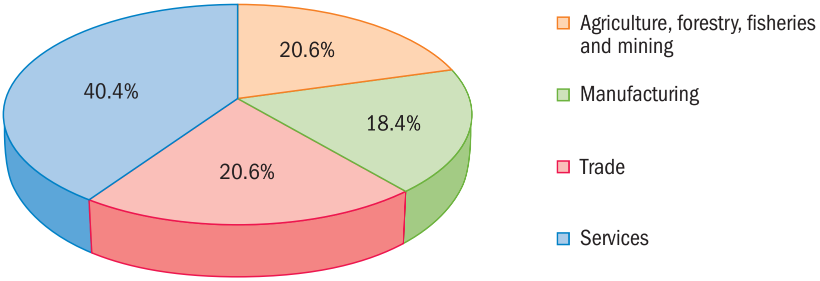
Sectors

In section 1.2, we defined a company as a profit-oriented production organization. The company aims to make a profit by purchasing resources and transforming them into goods or services that are sold at a price higher than the prices paid on the purchasing market.
Below you will find a rough classification of companies according to the nature of the transformation process:

- primary sector: agriculture and forestry, fishing and mining
- secondary sector: manufacturing
- tertiary sector: trade
- quaternary sector: services

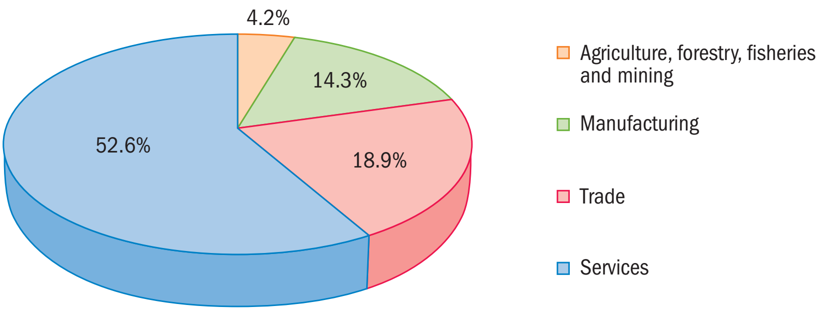
Figures 1.3a and 1.3b provide an overview of the percentage importance of the four sectors in the European and Dutch economy.

FIGURE 1.3a Number of companies per sector in Europe (2016)



Source: Eurostat

FIGURE 1.3b Number of companies per sector in the Netherlands (2019)



Source: CBS

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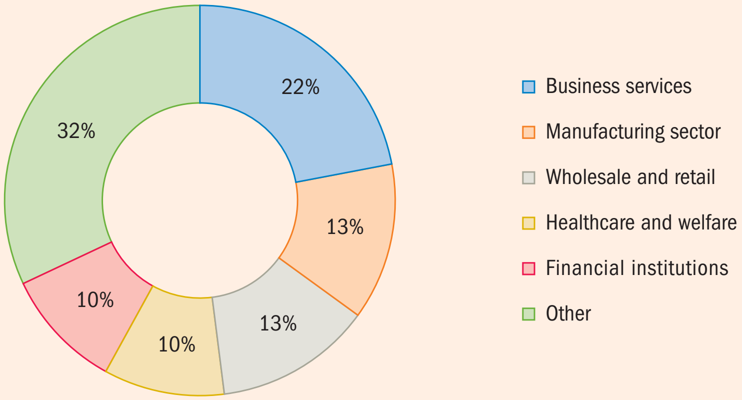
The striking difference between the share of the primary sector in Europe and in the Netherlands is explained by the strong automation and takeover of small farms in the agricultural sector in the Netherlands. Especially in Eastern European countries, you can still find many small farms. The average size of a farm in Romania is 3.6 hectares for example, while in the Netherlands this is 32.5 hectares.
The already great importance of the service sector is still growing. A survey by business information specialist Graydon into the growth of the number of Dutch companies in the first quarter of 2019 shows that the largest growth is in business services.

Growth of companies per (sub) division 1st quarter 2019



Agriculture and forestry, fishing 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 the extraction of mineable minerals, such as gold or copper, and commodities such as gas or oil, do not use up raw materials 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 – a lot of equipment may also be required.

Manufacturing

Manufacturing 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 tailored to customer requirements and products are made to order: a sale is agreed upon before production starts.

Job production

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.

Mass production

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.

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. 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, it 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 1.2 describes a situation in which each of these four forms of inequality occur.

EXAMPLE 1.2
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 items 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 its consumers live (4).

1

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 wholesale and retail trade. *Retail trade* is the final link in the chain, supplying directly to the end user: the consumer. *Wholesale trade* purchases from the manufacturer and redistributes the purchased goods among retail trade. 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.

Retail trade

Wholesale trade

Trading costs consist mainly of purchased merchandise. Other fixed assets such as buildings, cars and so on are also involved. The cost of human labor can also be significant, especially in retail.
Due to the emergence of online trade, there are major shifts in the trade industry as a whole. Retail trade, in particular, is under pressure due to wholesale traders offering their products directly to customers through web shops.

Services

Service companies provide a service to their customers without manufacturing a new product or redistributing an existing one. Think of:
- 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. Think of 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.

TEST QUESTION 1.5

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?

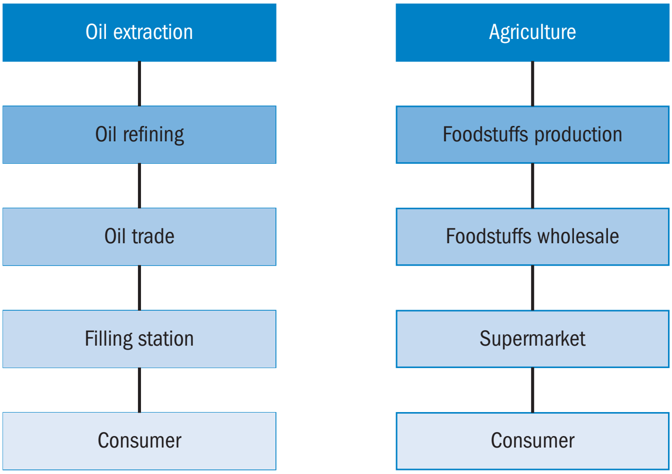
1.5 Supply Chain and Industry

A company almost never independently takes care of the entire process from the extraction of raw materials to the sale of a finished product to the customer. Usually, a succession of companies supplies each other with raw materials or semi-finished products to carry out the next processing step in the creation of the end product. This is called 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.
Figure 1.4 shows two supply chains.

FIGURE 1.4 Supply chains



The companies that make up a link in a chain form an industry. For example, all supermarkets form an industry.

Vertical integration

It is not uncommon for a company to be responsible for several successive links in a chain. Royal Dutch Shell, for instance, extracts raw oil, processes it in refineries into saleable products such as diesel and petrol, and sells them at the pump. This is called vertical integration.
Incidentally, not every Shell petrol station is owned by Royal Dutch Shell. Independent entrepreneurs could also buy their products from Shell. We will discuss this form of cooperation in the next section.

Horizontal integration

Companies can also be active in a similar link in different supply chains. An example is a petrol station that not only sells diesel and petrol, but also has consumer goods in its shop, such as soft drinks, ice cream, sweets, sandwiches and even a complete range of food. Such a broadening of the product range is a form of horizontal integration.

Some companies have become so big that they operate in different links of different supply chains. In the past, many large companies were established that operated in various links of different supply chains.

The argument was that this was a good way of spreading the risk.

Conglomerates

Nowadays, these conglomerates are no longer popular, because it has become apparent that it is very difficult for central management to control a mix of different business units. Hence, a trend that can be characterized as ‘back to the core business’ has been observed in recent years. Companies are starting to concentrate on their core activities and are selling off business units that do not fit in.

1.6 Types of Cooperation between Companies

In the previous section, we talked about companies that are active in different links of one or more supply chains.
Companies can cooperate to varying degrees with other companies. In doing so, they abandon their independence partly or entirely. What was formerly a competitor has now become a colleague.
Below, we will discuss four forms of cooperation: mergers and takeovers, joint venture, franchising and cartelization.

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 of another company. A *merger* is a situation in which two equal parties join together.
Although a takeover is a quick way to grow, the expected positive effects are often overestimated. It is estimated that 65% to 85% of takeovers fail in the sense that the merged company adds little value compared to the original separate companies. Reasons for this are for instance cultural differences between the companies or insufficient realization of cost savings through increased efficiency.

Joint venture

Joint venture

A *joint venture* is a cooperation between two companies in which they set up a new business together. The participating companies jointly own the joint venture and share both profits and losses. The participating companies continue to exist independently.
The cooperation can cover a wide range of activities. The companies may, for example, engage in joint research and development, take care of production, launch a new product or enter a new market.

Advantages of cooperating in a joint venture rather than operating separately may be:
- Achieving economies of scale quickly with the associated efficiency benefits
- Making use of each other’s knowledge and technology
- Use each other’s sales and distribution systems
- Opening up foreign markets when cooperating with a foreign partner if a country’s government prohibits direct imports or imposes very high import duties.

Well-known joint ventures in the coffee industry are Senseo, Dolce Gusto and Nespresso, and VodafoneZiggo in the media world.

Franchising

A very common form of cooperation in both the manufacturing and service sectors is franchising. The Dutch Franchise Association describes franchising as follows:

Franchising

> *Franchising* is a close form of cooperation between legally independent entrepreneurs, the franchisor and the franchisee, offering products and services to customers under a common name and uniform appearance.

In franchising, an independent entrepreneur joins a chain and uses certain facilities, such as purchasing, marketing and shop design.
For the franchiser, it is important that the entrepreneur is familiar with the local market. The franchisee runs the company as if they were an independent entrepreneur, but they position 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. Well-known examples of franchise concepts are Sport 2000, McDonalds and De Hypotheker.

Cartelization

A cartelization is an agreement between independent producers, restricting free competition. The opportunity to draw up such agreements depends on the market structure in which the companies operate.

Competitive market

Monopoly

In a perfectly *competitive market*, many companies offer a standardized product to many customers. This results in harsh competition. The other extreme is a *monopoly*, in which there is only one provider and therefore no competition.
Cartels do not exist under either competitive markets or monopolies.

Oligopoly

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

TEST QUESTION 1.6
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. Because cartel agreements are illegal, they are drawn up in secret, which makes it difficult to prove their existence. The Leniency Notice encourages companies to provide inside information on cartel agreements to the European Commission. The first participant in a cartel agreement 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 obviously also have important consequences for business economics.

EXAMPLE 1.3

In 2019, it was announced that the European Commission is investigating illegal agreements by German car manufacturers. If proven, the car cartel is one of the biggest cartel cases in German history. Five German car brands - BMW, Daimler and VW with Volkswagen, Porsche and Audi - are alleged to have made agreements over decades to delay the introduction of clean technology. The European Commission is investigating prohibited agreements on the import of particulate filters in petrol cars and on the size of tanks containing the liquid that helps clean exhaust fumes from diesel cars. Daimler says it will not be fined because it has reported the cartel to the authorities. Volkswagen says it wants a discount because it cooperated with the authorities. The manufacturers could, however, face claims from customers.

Glossary

Budget mechanism	Determination of the production of (public) goods through a budget (set by the government).
Business	Production household that manufactures goods and/or services and sells them to consumers at a specified price.
Business economics	Part of economics that deals with the economic actions within companies.
Capital	The production factor that consists of the raw materials and fixed assets of the enterprise.
Cartel	Agreement between companies whereby arrangements are made to restrict competition.
Company	Profit-seeking production organization.
Conglomerate	Company operating in different links of different supply chains.
Continuity	An organization's commitment to long-term survival.
Costs	The value of the means of production sacrificed for turnover.
Economics	Science concerned with man's pursuit of prosperity, i.e., the optimal provision of goods and services.
Effectiveness	The purposefulness of the production process; producing goods or services that are valued by the customer.
Efficiency	The efficiency of the production process; producing a given quantity with the least possible cost.
Franchising	Formula in which an independent entrepreneur, on payment of a fee, joins a chain in order to use certain facilities of this chain.
Horizontal integration	Performing activities in the same link of different supply chains.
Industry	The joint enterprises in a link of the supply chain.
Job production	Method of production where each product is tailored to the specific needs of the customer.

Joint venture	Partnership between two companies, in which they set up a new business together.
Manufacturing	Manufacturing companies create new physical, tangible products.
Market mechanism	The free play of supply and demand through which prices for goods and services are established.
Mass production	Mode of production in which a type of product is made in large quantities.
Merger	Merger into one entity of two or more previously separate companies.
Monopoly	Market form with only one provider.
Nonprofit organization	An organization that does not seek profit but has a mostly social objective.
Oligopoly	Market form with a relatively small number of providers.
Organization	Collaborative arrangement of people and resources, in which the achievement of a particular goal is the primary objective.
Perfect competition	Market form with many providers of and demanders for a standardized product.
Production	The creation of goods and services that can serve to meet human needs.
Profit	The difference between sales revenue and costs.
Public sector	Consists of national, state/provincial and local governments and provides primarily public goods and services.
Sales revenue	Income derived from the sale of products or services.
Services	Service companies provide services (non-tangible products) to customers.
Supply chain	Series of companies that follow one another in the processing of a product.
Takeover	Merger of companies where one company buys out the shares of another.
Trade	Trading companies deliver existing physical products to customers.
Vertical integration	A company operates in successive links of a supply chain.

Multiple-choice questions

Section 1.1

1.1 Which of the following statements is correct?
- **a** Business economics is part of general economics.
- **b** Business economics is part of macroeconomics.
- **c** Business economics is part of microeconomics.
- **d** None of the above statements is correct.

1.2 Which of the following statements is incorrect?
- **a** Business economics focuses on the operations of manufacturing organizations.
- **b** Another name for a production organization is a business.
- **c** A company is a special form of a business.
- **d** A company is focused on making a profit.

1.3 Which of the following statements is correct?
- **a** Macroeconomics and microeconomics together form general economics.
- **b** Macroeconomics and business economics together form the science of economics.
- **c** Microeconomics and business economics together form the science of economics.
- **d** None of the above statements is correct.

Section 1.2

1.4 Which of the following statements is *incorrect*?
- **a** Every business is a company.
- **b** A business is a cooperative venture of the factors of production labor and capital.
- **c** Shareholders are among the company's participants.
- **d** In the production process of a business, raw materials, fixed assets and labor are transformed into finished products.

1.5 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.

1.6 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.

Section 1.3

1.7 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.

1.8 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.

1.9 Which of the following statements is correct?
- **a** Profit is the measure of a nonprofit organization's efficiency.
- **b** Profit is the measure of a nonprofit organization's effectiveness.
- **c** The pursuit of profit is not an objective of a nonprofit organization.
- **d** Nonprofit organizations do not receive revenue from clients.

Section 1.4

1.10 Which of the following statements is *not* correct?
- **a** A service company hardly purchases any raw materials.
- **b** Mass production focuses on production to build 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.

1.11 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.

1.12 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.

Section 1.5

1.13 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.

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

1.15 A gas station will also perform the function of a postal parcel collection point. By what term is this referred to?
- **a** Conglomerate.
- **b** Vertical integration.
- **c** Horizontal integration.
- **d** Merger.

Section 1.6

1.16 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.

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

1.18 What is characteristic of a joint venture?
- **a** Two companies set up new company together.
- **b** An independent entrepreneur joins a chain.
- **c** Two producers make price agreements.
- **d** Formation of a monopoly by two companies.