

## ***EVALUATION OF BUSINESS'S PERFORMANCE***

**Marek Vochozka**

*Vysoká škola technická a ekonomická v Českých Budějovicích, Czech Republic*

### **Abstract**

*The paper deals with application of selected methods of comprehensive evaluation of the company. It aims to confirm usability of selected method during evaluation of a business's performance. It derives the economic situation of a particular company, using only a few versions of two bankruptcy models (Altman's analysis and Taffler's test) and two credibility models (Credibility Index and Kralicek's Quick test). It omits the traditional indicators of financial analysis and avoids the interpretation of sub-indicators. The paper values the company as a complex, as a system. In conclusion, it shows the possibility of prediction of the future development of the examined company financial situation. The main result is that used methods can really describe financial situation of a company. However they should be applied together.*

**Key words:** *bankruptcy, credibility, comprehensive business evaluation methods.*

### **Introduction**

The financial analysis provides information of the financial health of the company. It is therefore a methodical device which looks at sub-activity of company, evaluates their effects and helps to predict the results. Kislingerová (2004) divided the financial analysis into horizontal (compares state value in time), vertical (values share of individual units) and ratio (values the individual units always in relation with other units). The disadvantage of horizontal, vertical and ratio financial analysis is mainly the possibility to clearly interpret the results. All results are partial. However, their interpretation cannot be separated. A financial manager can find their value just in the interaction with other partial units. Financial analysis requires an extraordinary practical experience to be obtained valid results.

There are methods of complex valuating of the company in recent years which takes the value, there are "new" indicators for evaluating the company such as economic value added or market value added. Their contribution is mainly the possibility of simple interpretation (Kislingerová, 2001).

This leads to a situation where we choose to use the tool of financial analysis, their calculations are very accurate but there may exist a huge possibility that the results can be distorted or misinterpreted by the author. On the other hand we can choose the method of comprehensive evaluation of the company whose calculation is based on patterns derived by using statistical methods from a sample selected in a particular territory and time. However, this interpretation of the results is very clear. Result is always the value of the specified period. Comprehensive methods of evaluating the company are very often used only as a supplement of the financial analysis derived by methodology so-called Schmalenbach's companies or in the Czech Republic by professor Synek (Synek, 2003, Synek 2005).

The paper deals with the second group of indicators, it means solving a specific application of selected value and bankruptcy models on a practical example of Pražské silniční a vodohospodářské stavby, Inc. in the years 2003 – 2007.

Pražské silniční a vodohospodářské stavby, Inc. has been chosen mainly because of its returns are available to the public, the company is known and the results can be therefore easily confronted.

### **Purpose**

The purpose of this work is evaluating the financial situation of Pražské silniční a vodohospodářské stavby, Inc. using only selected comprehensive methods of evaluating company, respectively selected credibility and bankruptcy models.

### **Methodology**

There has been chosen two bankruptcy and two credibility models for the calculation. Bankruptcy models evaluate whether the company is able to survive any financial crisis. There has been chosen The Altman analysis as one of the bankruptcy models in a version for

companies traded on financial markets, not traded on financial markets and in the modification for the Czech environment and the Taffler index. Credibility models deal with the level of finance in the company. For this contribution there has been selected the Index of credibility and Kralicek Quick text in original version modified in 1999.

The Altman analysis for companies traded on the stock markets is based on the relationship (Altman & Eisenbeis, 1978):

$$Z = 3.3 * \frac{EBIT}{total\ assets} + 1 * \frac{incomes}{total\ assets} + 0.6 * \frac{market\ value\ assets}{book\ value\ of\ debt} + 1.4 * \frac{retained\ earnings}{total\ assets} + 1.2 * \frac{working\ capital}{total\ assets}$$

Where  $Z$  means Z-score (Altman's index),  
 $EBIT$  Earnings Before Tax and Interest.

Altman evaluates the company in the following intervals:

- \*  $Z > 3$ : a company is able to survive any financial pressure,
- \*  $1.8 < Z < 2.99$ : a company is located in the gray zone,
- \*  $Z < 1.8$ : a company declines.

In a version for businesses not traded on stock markets Altman changed the stress of used ratio indicators as follows:

$$Z = 3.107 * \frac{EBIT}{total\ assets} + 0.998 * \frac{incomes}{total\ assets} + 0.42 * \frac{market\ value\ assets}{book\ value\ of\ debt} + 0.847 * \frac{retained\ earnings}{total\ assets} + 0.717 * \frac{working\ capital}{total\ assets}$$

Altman evaluates the results of company analysis as follows:

- \*  $Z > 3$ : a company is able to survive any financial pressure,
- \*  $1.8 < Z < 2.99$ : a company is located in the gray zone,
- \*  $Z < 1.8$ : a company declines.

The third version, which professor Synek modified for the Czech companies, has brought an unique qualities – it considered a liabilities ratio after payback period and yields. He set the stress as negative. This means that the indicator tasks the companies and it is an important factor leading the company into bankruptcy. The adjusted relationship is as follows:

$$Z = 3.3 * \frac{EBIT}{total\ assets} + 1 * \frac{incomes}{total\ assets} + 0.6 * \frac{market\ value\ assets}{book\ value\ of\ debt} + 1.4 * \frac{retained\ earnings}{total\ assets} + 1.2 * \frac{working\ capital}{total\ assets} - 1 * \frac{liabilities\ after\ payback\ period}{yields}$$

The evaluating is based on the original for companies traded on the stock markets of the modeled form:

- \*  $Z > 3$ : a company is able to survive any financial pressure,
- \*  $1.8 < Z < 2.99$ : a company is located in the gray zone,
- \*  $Z < 1.8$ : a company declines.

The second selected model is Taffler index. It evaluates the results only in a statement whether the company is coming or not coming to bankruptcy. The gray zone is deleted:

- \*  $0.2 > T$ : a company is coming to bankruptcy,
- \*  $0.3 < T$ : a company is not coming to bankruptcy.

Taffler index is constructed in a similar way as the Altman Z-score. There are few ratio indicators which are:

$$T = 0.53 * \frac{EBT}{short - term liabilities} + 0.13 * \frac{assets}{foreign funds} + 0.18 * \frac{short - term liabilities}{assets} + 0.16 * \frac{incomes}{assets}$$

Where *T* means Taffler index,  
*EBT* Earnings before Tax.

Index of credibility divides the evaluating scale into several intervals. Of course, there is a question whether the finer segmentation of the intervals does not cause in its effect an incorrect interpretation of results:

- \*  $IB < -2$ : a company has an extremely bad value,
- \*  $-2 \leq IB < -1$ : a very poor value,
- \*  $-1 \leq IB < 0$ : a poor value,
- \*  $0 \leq IB < 1$ : some problems,
- \*  $1 \leq IB < 2$ : a good value,
- \*  $2 \leq IB < 3$ : a very good value,
- \*  $3 \leq IB$ : an extremely good value.

Index of credibility has been compiled in the same or rather a similar way as previous bankruptcy models:

$$IB = 1.5 * \frac{Cash Flow}{foreign funds} + 0.08 * \frac{assets}{foreign funds} + 10 * \frac{profit}{assets} + 5 * \frac{profit}{yields} + 0.3 * \frac{reserves}{yields} + 0.1 * \frac{yields}{assets}$$

The last model to be used is Kralicek Quick Test. This is not a purely credibility model but rather credibility-bankruptcy model. Original and modified version based on ratio indicators. The indicators are not balanced. Partial results are compared on the interval when belonging to a particular interval is the five-grade evaluation scale.

Original Kralicek Quick Text is evaluated in two intervals:

- \*  $2 \text{ points} > QT$ : value company (QT means Quick Test)
- \*  $3 \text{ points} < QT$ : company in bankruptcy

The method of calculating the value of original QT is shown in table number 1.

**Table 1: Kralicek Quick Test – original (calculating process)**

Indicator	Excellent (1)	Very good (2)	good (3)	bad (4)	Threatened insolvency (5)
$\frac{equity}{assets}$	>30%	>20%	>10%	>0%	≤0%
$\frac{(liabilities - financial assets)}{cash flow}$	<3 years	<5 years	<12 years	<30 years	≤30 years
$\frac{cash flow}{incomes}$	>10%	>8%	>5%	>0%	≤0%
$\frac{(net profit + expense interest(1 - income tax rate))}{assets}$	>15%	>12%	>8%	>0%	≤0%

Modified Kralicek text is softening the range of five levels:

- \*  $4 \text{ or more points}$ : this is a very good company,
- \*  $3 - 3.99 \text{ points}$ : a good company,

\* 2 – 2.99 *points*: an average company,

\* 1 – 1.99 *points*: a bad company,

\* 0 – 0.99 *points*: a very bad company.

The method of calculating the modified Kralicek Test is shown in table number 2.

**Table 2: Kralicek Quick test – modified in 1999 (calculating process)**

<b>Indicator</b>	<b>Excellent (1)</b>	<b>Very good (2)</b>	<b>Good (3)</b>	<b>Bad (4)</b>	<b>Threatened insolvency (5)</b>
$\frac{\text{equity}}{\text{assets}}$	<20%	<40%	<60%	<80 %	≥80%
$\frac{(\text{total liabilities} + \text{bank loan})}{\text{operating cash flow}}$	<20%	<40%	<60%	<80 %	≥80%
$\frac{\text{EBIT}}{\text{assets}}$	<20%	<40%	<60%	<80 %	≥80%
$\frac{\text{operating cash flow}}{\text{incomes of main operation}}$ or $\frac{\text{operating cash flow}}{\text{incomes for sold products, service}}$	<20%	<40%	<60%	<80 %	≥80%

At the end the statement parts of each method will be summarized in a single table to establish the last part of the text – Discussion of the results.

Meanwhile, however, there will be made a scaling of the results and the graph will be set from their sum (without balancing), to able to derive a trend of the financial situation development of the evaluated company.

### **Results**

The obtained results of comprehensive evaluated company can be summarized into several tables where we can find even a visible process of calculation and the partial results as well. All data for the calculation has been taken from the annual reports of Pražské silniční a vodohospodářské stavby, Inc. in the years 2003 – 2007.

The results of Altman analysis in all its versions are shown in table number 3.

Index in 2003 reached almost the value of 5. This period of an enterprise can be assessed as successful according to all applied variants of Altman analysis. In the positive zone, the company moved further in 2004. In later years, his results have worsened and the company got into a gray area. You're not quite able to objectively say whether the company will survive any financial crisis. The results indicate that modification of the original Altman analysis of the final statement had no effect.

Results of the Taffler Index are shown in table number 4.

**Table 3: Altman's analysis – the result and statement part**

<b>item/year</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
<b>EBIT</b>	100 215	74 884	91 152	94 251	83 783
<b>Assets</b>	512 001	666 845	1 567 570	1 486 825	1 726 708
<b>Incomes</b>	2 047 616	1 893 084	2 818 839	2 569 392	2 730 655
<b>Market value equity</b>	0	0	0	0	0
<b>Foreign funds</b>	507 681	687 148	1 058 030	912 613	0
<b>Retained profit</b>	70 888	50 134	85	60 350	0
<b>Pure working capital</b>	55 565	20 321	118 042	230 598	1 226 986
<b>Market value assets</b>	0	0	0	0	0
<b>Liabilities after payback period</b>	0	0	0	0	0
<b>Yields</b>	2 099 213	1 987 452	2 885 532	2 614 401	2 785 757
<b>EBIT/Assets</b>	0	0	0	0	0
<b>Incomes/Assets</b>	4	3	2	2	2
<b>Market value assets/Book-value of debt (foreign funds)</b>	0	0	0	0	0
<b>Retained profit/Assets</b>	0	0	0	0	0
<b>Pure working capital/Assets</b>	0	0	0	0	1
<b>Liabilities after payback period/Yields</b>	0	0	0	0	0
<b>Results for companies traded on financial markets</b>	4,97	3,35	2,08	2,18	2,59
<b>Statement</b>	Company is able to survive any financial pressure	Company is able to survive any financial pressure	Company is situated in the Grey zone	Company is situated in the Grey zone	Company is situated in the Grey zone
<b>Results for companies not traded on financial markets</b>	4,79	3,27	2,03	2,07	2,24
<b>Statement</b>	Company is able to survive any financial pressure	Company is able to survive any financial pressure	Company is situated in the Grey zone	Company is situated in the Grey zone	Company is situated in the Grey zone
<b>Modification suitable for Czech companies</b>	4,79	3,27	2,03	2,07	2,24
<b>Statement</b>	Company is able to survive any financial pressure	Company is able to survive any financial pressure	Company is situated in the Grey zone	Company is situated in the Grey zone	Company is situated in the Grey zone

**Table 4: The Taffler Index – the results and statement part**

item/year	2003	2004	2005	2006	2007
<b>EBT</b>	96 628	71 626	88 221	93 922	79 617
<b>Short-term liabilities</b>	420 708	551 314	982 583	813 918	0
<b>Short-term assets</b>	484 517	643 286	1 110 312	1 059 007	1 268 557
<b>Foreign funds</b>	507 681	687 148	1 058 030	912 613	0
<b>Assets</b>	512 001	666 845	1 567 570	1 486 825	1 726 708
<b>Incomes</b>	2 047 616	1 893 084	2 818 839	2 569 392	2 730 655
<b>EBT/Short-term liabilities</b>	0	0	0	0	0
<b>Short-term assets / Foreign funds</b>	1	1	1	1	0
<b>Short-term liabilities /Assets</b>	1	1	1	1	0
<b>Incomes/Assets</b>	4	3	2	2	2
<b>Result</b>	1,03	0,79	0,58	0,59	0,25
<b>Statement</b>	Company does not head for bankruptcy	Company does not head for bankruptcy	Company does not head for bankruptcy	Company does not head for bankruptcy	Company does not head for bankruptcy

The Taffler Index is purely bankruptcy model. It is limited to determining whether or not the company can survive any financial crisis. In this case, all partial results confirmed that the company does not tend to decline. Differences in the results of years may not be significant and from the perspective of this method is possible to speak about a standard and maybe a stable development.

Results of the Index of Credibility are shown in table number 5.

**Table 5: The Index of Credibility – the results and statement part**

item/year	2003	2004	2005	2006	2007
<b>Cash Flow</b>	-44 148	45 459	142 341	-72 764	102 743
<b>Foreign funds</b>	507 681	687 148	1 058 030	912 613	0
<b>Assets</b>	512 001	666 845	1 567 570	1 486 825	1 726 708
<b>EAT</b>	70 886	50 213	63 437	66 129	60 241
<b>Yields</b>	2 099 213	1 987 452	2 885 532	2 614 401	2 785 757
<b>Reserves</b>	83 728	118 811	133 704	121 873	103 516
<b>Cash Flow/Foreign funds</b>	0	0	0	0	0
<b>Assets/Foreign funds</b>	1	1	1	2	0
<b>EAT/Assets</b>	0	0	0	0	0
<b>EAT/Yields</b>	0	0	0	0	0
<b>Reserves/Yields</b>	0	0	0	0	0
<b>Yields/Assets</b>	4	3	2	2	2
<b>IB</b>	2,01	1,30	0,90	0,85	0,63
<b>Statement</b>	Very good value	Good value	Certain problems	Certain problems	Certain problems

The Index of Credibility doesn't evaluate only decline in business, but rather its ability to develop. The results, which the company achieved in this indicator is very similar numerical results to Altman analysis. The best evaluation is in 2003. After that it goes to a slight deterioration in 2004. Since 2005, there are identified some problems that the company may encounter. The company has assessed the tendency to decrease the profit, which must be clearly evaluated as a negative development. Although it made profits in all seasons, and in 2007 even very interesting values of cash flow, a problem causes an increase in the assets financed by own resources. This is probably the assets, which are not used in business or are underused. It is also clear that there is an increase in total revenues, but the decrease in profit after tax. We can deduce the margin decline, therefore, added value and efficiency of all business.

Results of the original Kralicek Quick Test are shown in table number 6.

**Table 6: Original Kralicek Quick Test – the results and statement part**

item/year	2003	2004	2005	2006	2007
<b>Equity</b>	478 960	461 751	444 208	507 645	0
<b>Assets</b>	512 001	666 845	1 567 570	1 486 825	1 726 708
<b>Foreign funds</b>	507 681	687 148	1 058 030	912 613	0
<b>Operating Cash Flow</b>	104 682	131 675	283 816	-39 772	-6 060
<b>EBIT</b>	100 215	74 884	91 152	94 251	83 783
<b>Incomes</b>	2 047 616	1 893 084	2 818 839	2 569 392	2 730 655
<b>Equity/Assets</b>	94%	69%	28%	34%	0%
<b>indicator 1 (mark evaluation)</b>	1	1	2	1	5
<b>Foreign funds/Operating Cash Flow</b>	4,84974494 2	5,21851528 4	3,72787298 8	- 22,9461178 7	 0
<b>indicator 2 (mark evaluation)</b>	2	3	2	1	1
<b>EBIT/Assets</b>	20%	11%	6%	6%	5%
<b>indicator 3 (mark evaluation)</b>	1	1	3	3	4
<b>Operating Cash Flow/Incomes</b>	5%	7%	10%	-2%	0%
<b>indicator 4 (mark evaluation)</b>	4	4	3	5	5
<b>Average mark</b>	2	2,25	2,5	2,5	3,75
<b>Statement</b>	Bankruptcy company	Bankruptcy company	Bankruptcy company	Bankruptcy company	Bankruptcy company

The Kralick Test evaluates the situation in company very skeptically during whole time period. Always the firm is located in a zone that marks the bankruptcy threat. If we look at numerical results, we find out that Kralick Test result in 2003 is borderline. It lacks only a small step to the zone which might label it as trouble-free undertaking. Again, you can identify the cause of a substantial increase in volume of assets. A comparison of EBIT and EAT we confirm that the added value has dropped. As another possible cause, seems to be a big drop or even the elimination of external sources. If such a cause of development of external sources, it indicates that capital costs are significant. The company would have to consider re-engagement of foreign capital into the structure of their resources. The amount of

debt and equity capital should be derived not only by their price, but also by the risks associated with their use. The debt may be made to the risk of loan defaults, increase the cost of credit, etc.

Results in 1999 of modified Kralicek Quick Test are shown in table number 7.

**Table 7: Modified Kralicek Quick Test – the results and statement part**

item/year	2003	2004	2005	2006	2007
<b>Equity</b>	478 960	461 751	444 208	507 645	0
<b>Assets</b>	512 001	666 845	1 567 570	1 486 825	1 726 708
<b>Liabilities</b>	433 538	567 750	990 666	833 571	0
<b>Financial assets</b>	103 917	239 876	649 792	218 734	239 774
<b>Cash flow</b>	-44 148	45 459	142 341	-72 764	102 743
<b>Incomes</b>	2 047 616	1 893 084	2 818 839	2 569 392	2 730 655
<b>EAT</b>	70 886	50 213	63 437	66 129	60 241
<b>Expense interests</b>	3 587	3 258	2 931	329	4 166
<b>Income tax</b>	0	0	0	0	0
<b>Equity/ Assets</b>	94%	69%	28%	34%	0%
<b>Indicator 1 (mark evaluation)</b>	5	4	2	2	1
<b>(Liabilities-Financial assets)/Cash Flow</b>	-747%	721%	239%	-845%	-233%
<b>Indicator 2 (mark evaluation)</b>	1	5	5	1	1
<b>Cash Flow/Incomes</b>	-2%	2%	5%	-3%	4%
<b>Indicator 3 (mark evaluation)</b>	1	1	1	1	1
<b>(EAT+ Expense interests*(1-Income tax))/Assets</b>	15%	8%	4%	4%	4%
<b>Indicator 4 (mark evaluation)</b>	1	1	1	1	1
<b>Average mark</b>	2	2,75	2,25	1,25	1
<b>Statement</b>	Average company	Average company	Average company	Bad company	Bad company

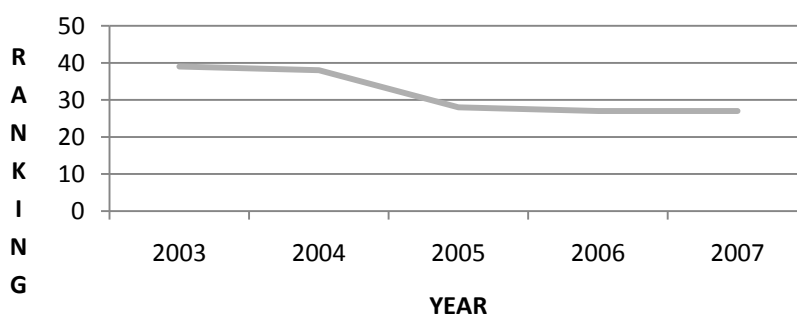
Modified Kralicek Quick Test evaluates the company in years 2003 – 2005 as average. And between 2006 and 2007, according to the evaluation method is deteriorating and the company is marked as bad. The reasons are essentially the same analysis already completed. An increase assets and decrease in value added. Moreover, growth of financial assets or their considerable fluctuations are accented.

Statements of each used methods are different between. It is therefore necessary to make a summary, scale, results and to prepare the conditions for estimating the trend of developing financial situation with the evaluating company. In table number 8 there are summarized the statement parts of each used methods.

**Table 8: Summarization of the statement parts of the used methods**

item/year	2003	2004	2005	2006	2007
<b>1. The Altman´s analysis</b>					
<i>1.1 Companies traded on the financial markets</i>	Company is able to survive any financial pressure	Company is able to survive any financial pressure	Company is situated in the Grey zone	Company is situated in the Grey zone	Company is situated in the Grey zone
<i>1.2 Companies not traded on the financial markets</i>	Company is able to survive any financial pressure	Company is able to survive any financial pressure	Company is situated in the Grey zone	Company is situated in the Grey zone	Company is situated in the Grey zone
<i>1.3 Modification suitable for the Czech companies</i>	Company is able to survive any financial pressure	Company is able to survive any financial pressure	Company is situated in the Grey zone	Company is situated in the Grey zone	Company is situated in the Grey zone
<b>2. The Taffler Index</b>	Company does not head for bankruptcy	Company does not head for bankruptcy	Company does not head for bankruptcy	Company does not head for bankruptcy	Company does not head for bankruptcy
<b>3. The Index of Credibility</b>	Very good value	Good value	Certain problems	Certain problems	Certain problems
<b>4. Kralicek Quick Test</b>					
<i>4.1 Original version</i>	Bankruptcy company	Bankruptcy company	Bankruptcy company	Bankruptcy company	Bankruptcy company
<i>4.2 Version modified in 1999</i>	Average company	Average company	Average company	Bad company	Bad company

The graphics evaluation of the development of the financial situation of Pražské silniční a vodohospodářské stavby, Inc. in the years 2003 – 2007 is shown in the picture number 1.



**Figure 1: The graphics illustration of the development of the financial situation of Pražské silniční a vodohospodářské stavby, Inc. in the years 2003 – 2007**

In 2003 the company was in its best situation sorted by the majority of the used methods. This situation has been stated by all versions of the Altman analysis, Credibility Index, and modified Kralicek Quick test. On the contrary original Kralicek Quick Test identified company as a bankruptcy company.

In 2004 is the situation nearly equal. Only the Credibility Index deteriorated from very good value to good value. Then the results got worse. The worst situation was in 2007. The company got only 27 points (against 39 points in 2003). Between years 2003 and 2007 there was an evident deterioration of the economic situation of the company.

### Discussion of the results

Enterprises may be recommended, particularly to reduce the number and value of total assets. This will increase the effectiveness of remaining assets. This will reduce depreciation and increase margins and added value will be adequate. In no case, however, may experience decreased performance. If the total revenue remains at the level of 2007, profits increase dramatically.

Whit respect to relevance of the used methods, the situation is not entirely clear. Some methods evaluated the firm on the basis of the same data differently. The question therefore arises whether the predictive value of each method is relevant.

Essentially it is a method of undertaking a comprehensive evaluation based on a statistical basis, namely the multiple discriminant analysis. This allows you to identify the nature of their negative aspects, which affect the predictive value of the above methods of undertaking a comprehensive evaluation (Vochozka, 2010):

- \* bipolar assumption of dependent variables,
- \* methodology for collecting data set of sample firms,
- \* assumption of stationarity and data instability,
- \* selection of independent variables,
- \* usage of annual financial statements of accounts,
- \* time dimension.

Regardless of evaluation the validity of the used methods we can state quite integrated results. It can thus be stated that the evaluation through the used bankruptcy and valid models has a significant explanatory capability. I must however recommend the use of a set of methods to be able to interpret the results with some rate of accuracy. I recommend referring to the results using the original Altman analysis, modified Kralicek Quick Test, Taffler Test and the Index of Credibility.

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### About the author

Ing. Marek Vochozka, MBA, Ph.D.  
Institute of Technology and Business in Ceske Budejovice  
Department of Economy and Management  
e-mail: vochozka@mail.vstecb.cz