

POSSIBLE RISKS IN THE VALUATION PROCESS

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Abstract

The aim of this paper is to determine the value of the company using the principle of going concern through the business method and states possible risks in this process. The article contents several parts, first of them is describing the historical review of valuation methods and shortly states international standards used in expertise. Assumption of using this method is, that evaluated company expecting good results in the future, because we apply going concern principle. In the process of determining the value, in accordance with the opinion of several authors, we encounter different valuation techniques, which also bring us different results. Each method has therefore their risks, negatives, positives, or limitations. Than we determine value of company XY, which does not wish to be named. Valuating process has several steps, in which we explain the procedure for determining the value of that company.

Key words:

enterprise value, going concern principle, business method, withdrawable sources, continuing value

JEL Classification: C53, L26, M21

Introduction

It is often necessary to know the value of a company, because investors -existing or potential, shareholders, creditors, managers want to know this value. When valuing a company, the main task is to determine the so-called "Real value of the enterprise". However, it is important to point out, that there is no such thing as an objective value for the companies. Such value could be the value of the acquisition costs were incurred from the company's assets, and thus to estimate how much the given assets would cost in the re-acquisition. The potential risk subsequently arises from the discrepancy of values in the acquisition of assets in the past and in the current period.

Whereas the objectivized value does not exist in process valuation possible risks follows from this fact. There is no unique and exact methodology to determine the value of a company. The value is not objectively attributable to a company, we can exactly determine its sales or number of employees, but there are no objective criteria which would allow us the determine the exact value. In process setting the value plays very important role the assessor.

If two assessors received the same result, it would be a coincidence, because is

usual, when two assessors get two different results, even when applying the same valuation method. There are several valuation methods, each of them having several modifications, because many factors affect it, which is necessary to take into account and we can calculate the different value, what mean different results for the same company. These risks can create despite the fact that some methods use exact mathematical models.

Crucial to determining the value of a company is the fact that even its past costs and revenues are not decisive for its present value. (Koller, T. et al. 1990) The value of a business is defined by expected future income, whether at the level of owners and creditors, which is discounted to their present value. It is also important that to consider the unlimited life of the company is considered - the principle of so-called going concern. ((Ross, S. – Westerfield R.:(2013)

1. Historical overview of valuation methods

The bases of using present value as one of the valuation methods date back to the beginning of the 20th century. One of the important representatives was Alfred Marshall from the Cambridge school and Eugen von Böhm-Bawerk

from the Austrian school. Modern approaches to company valuation can be found in the works of the American marginalist as well as co-founder of modern economics Irving Fischer in *The Rate of Interest*, from 1907 as well as *The Theory of Interest* from 1930. He presented here four alternative approaches that are suitable for investment analysis. These procedures led to the same results and the basic principle was always based on a comparison of two investments. The preferred variant was characterized by the following features:

- Higher present value at the same market rate,
- The highest difference in the present value of the benefits over the present value of the costs,
- The highest difference in the rate of return above the market interest rate,
- Compared to the other most costly investment, returns in excess of the rate of return should also exceed the market interest rate. (Sabolovič, M.:(2013).

These basic assumptions for evaluating the effectiveness of investments represent the basic criteria for investment decisions, too. The first two points represent the principle of net present value, the third point represents the internal rate of return (hereinafter IRR).

The last point represents the rate of return. (Fernández, P.: (2007) (Later, in 1939, according to the prominent economist J. M. Keynes, the marginal efficiency of capital was calculated as a discount rate that balances the present value of rate of return on assets (ROA) with the present value. (Keynes, J.M.: (2008)

In the 1950s, cash-flow-based models began to be used, mainly stock markets and, of course, corporate valuation. At present, according to the International Valuation Standard (hereinafter IVS), the discounted cash flow (hereinafter DCF) method is considered to be the basic valuation method.

IVS were defined by the International Committee on Asset Valuation Standards, established in 1981.

Using IVS are followed three basic goals (International Valuation and Standards 1981):

- make easier cross-border transactions and increase transparency in financial reporting,

- serve as a professional basis for experts worldwide and enable them to respond to the latest valuation needs,
- provide valuation standards that meet the needs of developing countries.

2. The procedure for valuing the company

The general value is determined by an assessor estimate and is the most probable price of the assessed asset at a certain valuation date, including to the condition of an appropriate degree of information and caution and provided that the price is not affected by unreasonable intent. Assessor activity may be performed by experts who are registered in the list of experts maintained by the Ministry of Justice of the Slovak Republic. It is a matter of course to proceed in accordance with the valid expert legislation. The valuation of companies' assets is regulated by the Decree on the Determination of the General Value of Assets (605/2008 Coll.), which regulates the specific method and methods of determining the value of assets.

Valuation is applying in these cases: buy or sell the whole company or a share on it. The seller will be interested in the maximal price and on the other hand the buyer in the minimum buying price.

Valuation is necessary the acquisition or merger, or the company need the loan, decision if to consolidate or reorganized company if is liquid. When subject need more financing sources and will issue new shares, in the case of change in legal form, and insurance payment of taxes.

Proceeding of valuation is like all processes in life, determining the value of a company has its own way. According to Mařík (Mařík, 2018, p.45), the basic recommended procedure in the process of company evaluation is as follows:

- a) Collection of basic input data,
- b) Analysis of collected data,
- c) Elaboration of financial analysis and compilation of financial plan,
- d) Evaluation.

In order to compile a completion financial analysis, it is necessary to supplement by the individual statements with financial and economic strategic plans for the future. It goes

e.g. o a possible plan for the sale of assets, payment of shares and dividends, resp. payment of shares in the profit of shareholders. (Hitcher, J.:(2011)

3. Setting value according Slovak legal framework

Setting value in Slovakia is determined by the Decree on the Determination of the General Value of Assets (605/2008 Coll.), which regulates the specific method and methods of determining the value of assets. Regulates the methods and proceedings that should be applied when we determine the value of a company as a whole should be determined, or the value of asset item or even the value of assets that are not devoted to business activities. The regulation should be applied when the valuation is made by a certified assessor, on request of a public authority, as part of certain legal acts.

Determination of general value (hereinafter GV) of individual asset items

Basic value turned with objectification into general value. When the basic value of basic value is accounted value or replacement value, according to the character of the asset item, the general value is influenced by e.g. technical condition, influence of the market and other specific factors. The general value of an asset item is objectivized value of an asset item, the most likely value of an asset item in a certain place on a certain date, market value under the assumption of free competition in the market.

When both the seller and the buyer are properly informed and handle with caution and have no inappropriate motives. General value of inventories is general value of inventories multiply by coefficient of objectification. The coefficient of objectification is influenced by efficiency of inventories, their degree of liquidity, market position of the company in the market for inventories, average cost of capital used to finance the inventories, excess inventories, specific properties of the inventories, turnover ratio. (Brigham, E. - Houston, J.: (2014).

The business method determines the general value of an enterprise or its part by an assessor organization on the basis of "the capitalization of its withdrawable resources for the period in which the enterprise is valued. "

Withdrawable sources are defined as: "the monetary expression of a benefit derived from disposable gains, income, or the balance of cash flows arising from an enterprise's operations or parts thereof, or from components of an enterprise's assets and depends on its past performance, current market position, but above all from its expected development". For its application it is necessary to briefly state its basic requirements, in order we can determine the value of a particular company in next part of our paper.

Determining the value of the company is one of the management tools with which we can modify or find out the status the "financial health " of the company and thus improve it's the management as the whole or of its individual structures. However, the reasons themselves can be diverse and we can divide them according to whether they are related to the change of ownership of the company.

4. Method of Discounted Cash Flow (hereinafter DCF)

We know three modifications of these methods. Two of them are based on income:

1. Method of Discounted Cash Flow of Firm = Free Cash Flow to The Firm (hereinafter FCFF) it is value for both: debtors = debt repayment interest and for owners in payment of dividends.
2. Method of Discounted Cash Flow of Equity (hereinafter DCFE) = Free Cash Flow to The Equity (hereinafter FCFE) it is value only for owners.
3. Method of Discounted Cash Flow Adjusted Present Value (hereinafter DCF APV) is used rarely, because the assumption is zero debt, while discount rate is equal to cost on own capital and present value of tax savings on interest because interests are a deductible item of profit before tax.

Important assessment basis is financial plan and we must have a detailed and accurate financial plan. An advantageous of this method is more accurate the company value assessment. The advantage of these methods over the method of discounting profits is that the cash flows are not so much

affected by the accounting used policies. In addition, they show a greater stability over time than net gains, which may be influenced by frequent and significant changes mainly as a result of extraordinary events. Risks result from a disadvantage of DCF methods, what is the inability to plan future investment expenditures with sufficient accuracy, and thus free cash flows.

Calculation procedure:

Adjusted Net Operating Income (hereinafter NOI) (calculated e.g. by elimination of non-operating & one-off costs and revenues)

– Tax on NOI

= NOI after taxes

+ Depreciation

± Change in reserves and adjustments

– Increase in working capital (needed for only operating activities)

– Investments into long term assets (needed for operating activities)

= Free Cash Flow to Firm (hereinafter FCFF)

– Interest from Debt adjusted by taxes = interest x (1 – tax rate)

– Increase in volume of loans = new loans taken – loan repayments

= Free Cash Flow to Equity (hereinafter FCFE).

Advantage of these method is with compared with Net Income (hereinafter NI) that result is not so influenced by accounting methods, over time, CF stream or more stable than NI stream.

On the other hand, the possible risks can occur because is necessary the very accurate current financial plan needed and the fact, that some data are not easy to predict (e.g. investments.) and it is a disadvantage of this method.

5. Application of business method of determine value

The business method determines the general value of an enterprise or its part by an assessor on the basis of "the capitalization of its withdrawable resources for the period in which the enterprise is valued." (Parkinson, A:(2014). Withdrawable sources are defined as: "the monetary expression of a benefit derived from disposable gains, income, or the balance of cash

flows arising from an enterprise's operations or parts thereof, or from components of an enterprise's assets and depends on its past performance, current market position, but above all from its expected development". For the application this business method for determining the value of a particular company is stated in next part of article. Business method capitalization is two phase income-based model. We can divide it: a) for unlimited company life, we can use formula:

$$GVe = Vws + Vc$$

While:

GVe = general value of enterprise (EUR),

Vws = value of withdrawable sources (EUR),

Vc = continuing value.

Value continuing (hereinafter Vc) is general value of withdrawable sources converted to the present value at the valuation date.

b) business model for company limited company life, we have to use formula:

$$GVe = Vws + Vc, GVe = Vws + Vf$$

While:

GVe = general value of enterprise (EUR),

Vws = value of withdrawable sources (EUR),

Vf = if final value of enterprise and it's parts which are converted to the present value at the valuation date. (EUR).

It is estimated net income from monetization of assets in the year following monetization (EUR).

6. The determination of value by business methods with going concern principle

In determining the general value of the company XY, the business method will be used due an unlimited company life for the following reasons:

- The company has submitted a financial plan to us, and the company expects to achieve a positive economic result in the future,
- The equity method would not take due account of the company's future planned profits and revenues, and is very static, therefore the business method of determining the company's general value was used,

- All information necessary for the use of the business method with an unlimited company life has been documented.

Calculation of the general value of withdrawable sources:

Interest-bearing borrowed capital - The company XY, does not have any interest-bearing borrowed capital as at 31 December 2018. When calculating the capital structure, we use the actual capital structure, while the share of interest-bearing borrowings is set at 0.00%.

Equity - The amount of the company's equity as at 31 December 2018 is registered at the level of EUR 305,834. When calculating the capitalization rate, we will be based on the actual capital structure of XY, while we determine the share of equity in the amount of: 100.00%.

Borrowed capital costs - as of the valuation date, the company does not record any interest-bearing borrowed capital, therefore we do not consider the cost of borrowed capital in further calculations.

The cost of equity capital is determined using the Capital Asset Pricing Model (hereinafter CAPM). Cost of equity capital (Ce) or more

precisely the return required by owners of equity capital was in line with the methodology determined according next formula:

Valuation of Capital Assets (CAPM) as follows:

$$C_e = R_f + \beta * (R_m - R_f) + SCP + AP,$$

Where:

Rf is the risk-free rate,

Rm is the expected average return on the capital market,

(Rm - Rf) is the average capital market risk premium required by investors as compensation for investing in risky securities,

β is the beta factor, reflecting the rate of systematic risk of a particular investment in relation to the risk of the portfolio of all risky investments,

SCP is a supplementary charge mark - reflecting the size of a company,

AP is an additional mark-up reflecting unique risks.

In terms of used methodology, it was necessary to determine the amount of cost of equity for the company, using the following sources of information and input values.

Table 3 Basis for calculation

Item	Comment	Determination method
Risk free rate	Earning required by investors due investing in a risk-free instrument	Average yield on government bonds, ISIN SK4120012691
Additional surcharge		
Capital market premium	Additional profit required by investors when investing in the so-called market portfolio; such profit also considers compensation for country risk,	Capital market premiums for individuals countries (defines Damodaran)
Beta coefficient	Relative risk parameter compared to market portfolio risk	Beta coefficient for the industry of company
Supplementary charge for size	Profit required by investors depending on the size of the company	0.8 times the capital market premium (according to methodology)
Additional charge	Evaluation of additional risks of the company	Additional charge of 15.00% because of: - commercial risk = 5.0%, - financial risk = 5.0%, - risks of non-compliance with the financial plan = 2.5% - Preventive charge = 2.5%.

Source: (Damodaran, A.: (2017)

The value of β was determined according to sectoral beta coefficients, which are published in the literature. We set the value of the unlevered beta coefficient at 0.54 (source: www.damodaran.com). The corporate income tax rate valid on the valuation date (31 December 2019) is 21%. Calculation of the cost of equity according to:

Results of government bond issues = ŠD 232 C according to www.ardal.sk

Risk-free rate = 1.6326%

Capital market premium = 6.06%

Non-indebted Beta = 0.54

Surcharge for size = 4.848%

Additional surcharge = 15%.

$$C_e = R_f + \beta \cdot (R_m - R_f) + SCP + AP = 1,6326 + 0,54 \cdot 6,06 + 4,848 + 15,00 = 24,75 \%$$

The rate of capitalization is one of the important factors influencing the final value. It is used to pay interests on future income, i.e. future resources. In Slovakia, in accordance with the applicable legislation, the calculation of the capitalization rate using the Weighted Average

Cost of Capital (hereinafter WACC) method is currently used, i.e. the weighted average costs for individual capital components. We work with a valid tax rate and not an effective tax rate, i.e. when evaluating we will apply a rate of 21%. Using the valid income tax rate for PO for 2018 the rate of capitalization is one of the important factors influencing the final value. It is used to pay interests on future income, i.e. future resources. The calculation of the capitalization rate is then as follows:

$$i = (1 - 0,21) \cdot 0,00 \cdot 0,00 + 24,75 \cdot 1,00 = 24,75 \%$$

The third step in this process is calculation of the sustainable growth rate, because we want to implement a calculation of the principle going concern. To formulate, we have to know the projected inflation rate for 2019, which was set by the National Bank of Slovakia on a level of 2.40%. Next, we proceeded to the analysis of the historical development of sales for the period 2014 – 2018.

Table 4 Development of sales of XY

Item	31.12.2014	31.12.2015	31.12.2016	31.12.2017	31.12.2018	Average
Revenues from own products and services	309 071	394 453	284 239	293 762	337 249	1,0446
Year-on-year change		1,2763	0,7206	1,0335	1,1480	

Source: own processing according to Tax returns of XY for the period 2014 to 2018

According to an analysis of the historical development of sales, we found that sales for the previous period grew by an average of 4.46%.

The fourth step in our calculation will be to proceed to the analysis of the forecast

development of sales from the financial plan for the next 7 future years, it means on the period 2019 to 2025.

Table 5 Forecast of sales development of the company XY:

Item	2019	2020	2021	2022	2023	2024	2025	Average
Sales of own products and services	343 993	350 873	357 891	365 049	372 350	379 797	387 393	1,0200
Year-on-year change		1,0200	1,0200	1,0200	1,0200	1,0200	1,0200	

Source: own processing according to financial plan XY for period 2019 till 2025

According to the results the expected development of sales is a growth of 2.00% per year. Given the precautionary principle, we set a sustainable growth rate of 1.50%.

The fifth step is the calculation of cash flow by the indirect method.

6th step: Earnings Before Interests of Taxes (hereinafter EBIT) for the calculation of

withdrawable sources for the years 2019 to 2025, we will be based on the profit after tax specified in the financial plan, with applying the current income tax rate (21%).

7th step: Depreciation and investments for the years 2019 to 2025 will be taken from the financial plan and their value are showed in next table.

Table 6 Depreciation forecast and investments of XY

Item	2019	2020	2021	2022	2023	2024	2025
Depreciation	29 919	32 845	34 236	34 479	34 687	34 865	35 018
Investments	0	26 793	40 167	35 513	35 574	35 626	35 671

Source: own processing according financial plan XY for period 2019 till 2025

8th step: For applying this method is necessary to calculate the increment of working capital increase (investments within working capital). Increment of working capital for the years 2018 to 2025 we were taken from the financial plan. The increment of Net Working Capital is sum of (Financial accounts + Short - term receivables

+Inventories +Accruals (assets)) minus Short - term liabilities. For example, in year 2019 it's equals $(157\ 039 + 60\ 169 + 2\ 700 + 17) - 11\ 546 = 208\ 380$. The Increment of NWC is differential $NWC(2019) - NWC(2018) = 208\ 380 - 45\ 271 = 163\ 109$.

Table 7 Increase in working capital of XY

Item	2018	2019	2020	2021	2022	2023	2024	2025
	Reality	Estimate	Estimate	Estimate	Estimate	Estimate	Estimate	Estimate
Financial accounts	104 741	157 039	159 305	152 494	152 730	153 211	153 907	154 794
Short - term receivables	41 383	60 169	61 373	62 600	63 852	65 129	66 432	67 761
Inventories	923	2 700	2 700	2 700	2 700	2 700	2 700	2 700
Accruals (assets)	17	17	17	17	17	17	17	17
Short - term liabilities	101 793	11 546	11 651	11 846	12 106	12 373	12 648	12 930
Accruals and deferrals	0	0	0	0	0	0	0	0
Net working capital (NWC)	45 271	208 380	211 743	205 966	207 193	208 684	210 408	212 342
Increment of NWC		163 109	3 363	-5 778	1 228	1 490	1 724	1 934

Source: own processing according financial plan XY for period 2019 till 2025

Table 8 Forecast of withdrawable resources of XY

Item	2019	2020	2021	2022	2023	2024	2025
Profit after tax	97 738	97 811	99 187	101 520	103 930	106 416	108 974
Depreciation	29 919	32 845	34 236	34 749	34 687	34 865	35 018
Investments	0	26 793	40 167	35 513	35 574	35 626	35 671
Increment of NWC	163 109	3 363	-5 778	1 228	1 490	1 724	1 934
Withdrawable sources	-35 452	100 499	99 034	99 258	101 553	103 930	106 387

Source: own processing according financial plan XY for period 2019 till 2025

9th step: Withdrawable sources in 2020 equal= SUM (Profit after tax + Depreciation) – SUM (Investments + Increment of NWC) = (97 811 +32 845) – (26 793+ 3 363) = **100 499**.

The general value of withdrawable sources for the period 2019 - 2025 with the calculated capitalization rate mentioned above (24, 75%) and its calculation is as follows:

Table 9 Calculation of the general value of withdrawable sources of XY

Item	2019	2020	2021	2022	2023	2024	2025
Years from the valuation date	1	2	3	4	5	6	7
Discount factor	0,802	0,643	0,515	0,413	0,331	0,265	0,212
Withdrawable sources	-35 452	100 499	99 034	99 258	101 553	103 930	106 387
Present value of withdrawable sources	-28 417	64 575	50 976	40 954	33 587	27 553	22 595

Source: Own processing above mentioned data

10th step: Calculation of the general value of Continuing value (hereinafter Cv) for the period 2019 - 2025 is, with considered rate of

capitalization 24.75%, in the amount of 97 286 EUR (calculated as the sum of current values for the analysed period 2019 to 2025).

$$\begin{aligned}
 C_v &= \frac{OZ_{t+1}}{i - g} * \frac{1}{(1 + i)^n} \\
 &= \frac{106\,387 \text{ (Withdrawable sources 2026)}}{0,2475 \text{ (rate of capitalization)} - 0,015 \text{ (from table Basis for calculation)}} * 0,2127 \\
 &= \mathbf{97\,286\,EUR}
 \end{aligned}$$

Where **i** is the sustainable growth rate = 24,75%, then in formula= $\frac{1}{(1+0,2475)^{n7}} = 0,21267 \doteq 0,2127$

Finally, the general value of withdrawable sources for the period 2019 - 2025 is, with the calculated rate of capitalization 24.75%, for EUR

211,823 EUR (calculated as the sum of current values for the analysed period 2019 to 2025).

$$V_{CT} = \frac{WS_{T+1}}{i-g} * \frac{1}{(1+i)^n} = \frac{106\ 387}{0,2475 - 0,015(\text{Additional surcharge})} * 0,2127 = \mathbf{211\ 823\ EUR}$$

Table 10 Calculation of the general value of XY

Item	General Value
The general value of withdrawable sources (V_{CT})	211 823
Continuing value (C_V)	97 286
The general value XY using going concern principle ($V_{CT} + C_V$)	309 109
The general value of XY using the going concern principle rounded *	309 000

Source: own procession according above calculations and (Sivák a kol. (2019)).

*Rounding is in accordance with Annex no. 5 to Decree no. 490/2004 Coll., Which implements Act no. 382/2004 Coll. on experts, interpreters and translators and on the amendment of regulations no. 500/2005 Coll., No. 534/2008 Coll., No. 33/2009 Coll.

The general value of XY using the principle of continuous operation is 309 000 EUR.

Conclusion

The main goal of our paper was to determine the value of the company by the business method using the principle of going concern. In the calculation, we used the procedure in accordance with Setting value in Slovakia is determined by the Decree on the Determination of the General Value of Assets (605/2008 Coll.), which regulates the specific method and methods of determining the value of assets. The resulting price is affected by a basnumber of factors that have a significant effect on it. These can be, for example, psychological factors, time constraints, personal relationships or skill of assessor in negotiation. In addition to the concept of "going concern", one factor is usually used, namely "stand-alone basis". In practice, this means the assumption that the company will continue to have the same subject of activity and will continue to do so. Before performing the evaluation, we found that the company has the prerequisites to operate in the future, because it achieves a positive value of withdrawable sources, which allowed us to use the business method with an unlimited life of the company - using the principle of going concern. According to Vernimmen, it is thus possible to distinguish between two evaluation methods - direct and indirect. In the case of direct, as the name implies, the company's equity is valued directly

as a whole. When using the indirect method, the enterprise as a whole is first valued first and then the net debt value is deducted.

In the current literature, however, it is also possible to find a somewhat more technical view of the matter presented by Damodaran. He divides the valuation methods into 3 ways. The first is valuation based on discounted cash flow, which combines the value of an asset with its current value of cash flow that the asset will generate in the future. The second way is the so-called relative valuation, where the value of assets is estimated on the basis of comparison with the value of other assets (mostly companies) and their relationship to accounting variables such as. profit, cash-flow, book value or turnover.

The last, third way, according to Damodaran, is the so-called contingent claim valuation, which uses option models to value assets. This method is based on the idea that some assets (such as an enterprise) carry certain features that have options.

However, Damodaran himself points out that different valuation techniques also bring different results, and therefore have their risks, negatives, positives, or limitations. We can only agree with this consideration and due these facts we also pointed out some of the risks associated with the evaluation process.

Acknowledgements

The contribution is processed as an output of a research project Financial risks and their impact on the credit cycle and their financial stability of the economy in the Slovak Republic. (Finančné

riziká a ich vplyv na úverový cyklus a ich finančnú stabilitu ekonomiky v SR) registered by the Ministry of Education of SR under the registration number : 1/0688/20.

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