The Macrotheme Review

A multidisciplinary journal of global macro trends

Czech Business Valuation Standard Proposal: Discounts and Premiums

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Abstract

The objective of our research is to prepare national standards for business valuation that would correspond with the Czech legal background as well as the specifics of the market and it´s structure. If these standards were generally accepted it could help to raise the quality of business valuation reports, lower the variance in resulting value estimates and it could be a useful support for business valuers who testify for example at minority shareholder or marital dissolutions law suites. This paper as a result of our research presents a proposal of Discounts and Premiums national standard for business valuation with added reasoning where necessary. Due to illiquidity of most of the Czech companies or stocks the estimation of illiquidity discount is one of the most objected parts of valuation reports. Minority discount (control premium) is a similar case. The standard proposal does not contain an exact way how to calculate these but it contains terminology, recommendations in which cases the discounts and premiums should be incorporated in the valuation as well as the factors that should be taken into account when estimating the value of a discount or premium and what the valuation report should contain.

Keywords: business valuation, standard, discount, premium

1. Introduction

Business Valuation in the Czech Republic has a 20 year history which started with the political changes from communistic to market oriented economy. New markets for companies have been created or re-opened (Prague Stock Exchange - PSE). For many years the PSE was very illiquid. Most of the stocks that were listed there were thinly traded. Stocks traded at the main market – SPAD were the only exception but today the number reaches only 15. The need for business valuation arose and in the same time. We were missing both the empirical evidence of the market prices close to the market value of the stocks, and the history and knowledge of business valuation. It was a new economic area and the start was rather unrestrained. As a result many business valuation specialists created their own approaches. They formed solutions for specific problems in business valuation, such as specific risk premiums when estimating a discount rate; relation between the purpose of valuation and the standard of value as well as the discounts and premiums. This situation resulted in big variance in the estimated company values. The problem was emphasized due to legalization of squeeze-out[1] (the right of a shareholder who owns 90% interest in a company to buy out all the minority interests) at 2001. Business valuation is legally demanded as a means of minority shareholder protection. There are many lawsuits going on endlessly due to this variance in value estimation. The International Valuation Standards are used by some professionals in the Czech Republic or at least partially used. But in some areas we face the problem of market and legal specifics as well as some practical problems like language barrier and terminology. Since the legal system in the CR is very different from the U.S. one, some of the international standards are too vague and not sufficient for our practice or use in law suits. The Czech business environment is rather comparable to the German one so part of our research is also focused on valuation standards in Germany (IDW).

2. Objective and scope

The objective of our research is to prepare national standards for business valuation that would correspond with the Czech legal background as well as the specifics of the market and it´s structure. If these standards were generally accepted it could help to raise the quality of business valuation reports, lower the variance in resulting value estimates and it could be a useful support for business valuers who testify for example at minority shareholder or marital dissolutions law suites. This paper as a result of our research presents a proposal of Discounts and Premiums national standard for business valuation with added reasoning where necessary. Due to illiquidity of stocks of most of the Czech companies the estimation of illiquidity discount is one of the most objected parts of valuation reports. Minority discount[2] (control premium) is a similar case. The standard proposal does not contain an exact way how to calculate these but it contains terminology, recommendations in which cases the discounts and premiums should be incorporated in the valuation as well as the factors that should be taken into account when estimating the value of a discount or premium and what the valuation report should contain. Since there is a lack of empirical data from our own markets it is generally accepted to use empirical evidence from other markets to estimate the discounts and premiums in the Czech Republic. Mainly empirical studies from U.S.A. are being used for these purposes. The lack of data is partly a consequence of the market environment that does not encourage companies to disclose the transaction information unless they are forced by law. Dyck and Zingales (2004) stated that Czech Republic is one of the worst countries concerning data disclosure and private benefits of control. The standard should also contain the main principles under which the empirical studies from abroad might be used in business valuation of the Czech companies.

The importance of business valuation standards is emphasized by the way how the courts rule in cases where business valuation is involved. The judges appoint a business valuer and desire "the objective value" of a business or "adequate value" of a stock and so on. They are usually not satisfied with an interval of values as a result; they do not say whether the "adequate" value should be the fair value or the market value for example. Since the system in the Czech Republic is different from the U.S. one, the judges do not have any economic knowledge or background not to mention business valuation, so we can hardly want them to decide whether a minority discount should or should not be used or about other specific things that are not completely clear

[1] The right of a shareholder who owns at least a 90% interest in a company to buy out all the minority interests. The minority interest owners are forced to sell. The transaction price is controlled by the state to be "fair".
[2] Minority and control as well as premium and discount are defined lower in the Standard Proposal

in theory and practice too. They took the path of a legally binding norm (in contrary to the form of professional standards common in other European countries) in the Slovak Republic. It solves the problem of variance in valuation estimations; on the other hand it does not enable business valuers to take into account each company´s specifics. On our opinion the form of standard is also preferable since it is more flexible and in hand of business valuation professionals in contrary to state clerks. In last couple years the University of Economics in Prague was granted financial funds from the Ministry of Education that were used for work on national standards. During these years there were many publications, discussions with business valuation experts and academics, experts from Czech national bank that is the body of valuation supervision for listed companies etc. So far, there is no other independent or other institution that would work on the same project in the business valuation area. The research was successful and standard proposals for all areas (business valuation, intangible assets, real estate, financial and insurance companies, discounts and premiums) are being published and even though they have just a form of proposal they are already being used in practice (for example some of the courts demand the business valuation report to comply with the standards). We hope in the future the University of Economics as an independent body could found an institute that would issue, discuss and amend these professional standards that would be generally accepted.

This Discounts and Premiums standard is not meant to be used independently but together with the other standards that were developed at the University of Economics, especially together with Czech Valuation Standard for Business Valuation (Marik, 2011). This standard is the key standard for business valuation and it contains the basic terminology (e.g. value and price, market, date of valuation), basis of value (market value, objectivized value, fair value..), the roles of business valuer (neutral, advisory, arbiter), general standards, valuation fundamentals, valuation methods as well as the structure of business valuation report. Therefore Discount and Premium standard does not have to deal with the general fundamentals.

3. Underlying research

Our research was focused in three directions: i) business valuation discounts and premiums from theoretical point of view, ii) international empirical evidence on valuation discounts and premiums, iii) standardization of discounts and premiums. The standard proposal is based on the knowledge gained through points i) and ii) that were the subject of my dissertation thesis (Rydlova, 2009). When creating the standard I have also taken an advantage of my practice as a business valuer. I have participated as a business valuer several lawsuits in minority shareholder cases and it has helped me see the most problematic or most sensitive issues in business valuation reports. Since the standard is one of the main outcomes of my research naturally I tried to find out about how discounts and premiums are adapted to standards in other countries. Since International Valuation Standards (IVS, 2011) are used by professionals in the Czech Republic but in the same time they are too vague in some areas, I concluded that the standard should comply with the IVS but should be tailored to the conditions of the Czech Republic. In other countries the national standards are developed in cooperation with the IVS Comittee, too. Due to globalizing economy, many global companies on the Czech market – companies that do the valuations as well as companies that are being valued, together financial reporting standardization I suppose it is not desirable not to comply with the IVS. Other business valuation standard that is being cited in the Czech Republic is German IDW standard (IDW S 1, 2005). Czech business, cultural and legal environment is much more similar to the German one than to the U.S. one so

German standards are the logical choice. The discounts and premiums are not very intensively standardized in Germany but the view of some basic principles has been used as a support for the Czech standard (for example the use of aliquot interest[3] on the value of a company as a whole for minority shareholders purposes). Concerning discounts and premiums I consider the American ASA Business Valuation Standard BVS-VII (ASA, 2009) together with Uniform Standards for Professional Appraiser Practice (The Appraisal Foundation, 2010) the most elaborate.

As mentioned above, the Czech National Bank (as the central bank of the CR) is a supervision body to supervise the companies that are listed at PSE in case of acquisitions or squeeze-outs. It should ensure that minority shareholders receive or are offered adequate consideration for their stocks. The CNB has issued a sort of methodology for business valuation for these purposes. It could be considered a kind of standardization act so I have also taken this methodology into account. In the future I suggest cooperation between the CNB and the standardization body so that the Czech BVS could be recognized by the CNB.

When preparing the Standards we have respected the legal demands of the Czech law as well as the European Union one (Directive 2004/25/EC of the European Parliament and of the Council on takeover bids). We have also found inspiration in the U.S. Model Business Corporation Act (ABA, 2005) which is not legally binding in the Czech Republic but it governs the rights and obligations in minority stockholder cases into more detail than the Czech law or EU Directive 2004/25, for example it defines “fair value” for minority stockholder cases and also the use of discounts and premiums.

The following part of the paper presents the proposal itself. Concluding part of the paper is dedicated to comments on some most problematic issues of the proposal.

4. Discounts and Premiums Standard

i) Preamble

a) The purpose of the Discounts and Premiums Standard is to determine the Framework for a special area of business valuation – first of all the estimation and application of the effect of liquidity and control on the value of ownership interests in companies (business shares or stocks). Adherence to the terms that are recommended by this standard should lead to meeting the general business valuation requirements as stated in the Czech Valuation Standard: Business Valuation (chapter 4: complexity, integrity, consistence, independence, neutrality and repeatability). If discounts and premiums are used in business valuation, the valuation should comply with this standard. If discounts and premiums are not used in business valuation, the report should contain reasoning, why they have not been used. This standard should not be used on a stand-alone basis, but together with the Czech Valuation Standard: Business Valuation.

[3] By aliquot interest we understand that for example a shareholder who owns a 5% interest on a company should recieve 5% share of the market value of the company when the right of squeeze-out is excersized by the majority shareholder.

b) A business (company) can be valued at **the enterprise level** regardless the actual ownership distribution (structure).

c) A business can be valued at the **shareholder level**. A value of a specific clearly defined ownership interest can be the object of valuation. The interest is clearly defined if the interest owner (or owners) is identified, if the size of the interest and amount of rights connected with this interest are identified. The entire ownership structure of the company should be identified (the distribution of ownerships rights among owners) as well and other information that could influence the value of the interest should be gathered, such as special stipulations (contractual, law-based or included in Articles of Incorporation) concerning transferability of the interest. This information should be included in the business valuation report in the valuer's determination chapter.

d) **Value of a specified ownership interest can differ from the pro-rata (aliquot) part of enterprise level value of the company.**

e) **A value of an ownership interest might be estimated either directly** (e.g. as the present value of the expected cash flow of the interest owner or through direct estimation of the value of the interest using market approach) **or indirectly.** Indirect estimation means that the valuer estimates the value of the company at the enterprise level[4] and subsequently the shareholder level value of the interest is derived.

ii) Definitions

a) **Liquidity** is the capability to convert an asset, business or an ownership interest, a security or an intangible asset to cash quickly and without a substantial loss of principal. Liquidity is related to the speed with which an asset can be converted into cash.

b) **Marketability** is the capability and the ease of transfer of an asset, business or an ownership interest, a security or an intangible asset. Marketability is related to various contractual or legal stipulations which affect the transfer of an asset. Marketability is also related to the existence of a market for the asset (e.g. stocks listed at a stock exchange). An asset can be marketable but still illiquid. Restricted or limited marketability has an effect on liquidity of the asset.

c) **Majority interest is an interest** that is connected with the majority of ownership rights of the business.

d) **Minority interest is an interest** that is connected with the minority of ownership rights of the business.

e) **Control** is the effectual influence on decision-making process of a company that can either originate in the volume of voting rights or it can originate in other stipulations (e.g. Articles of Incorporation).

[4] For example based on total expected CF of the company. The derivation of the value of the interest is then done based on the pro-rata value which might be altered using a discount or premium.

f) **Lack of marketability discount** is the excess value of a marketable asset over an asset with a limited marketability, expressed as a percentage of the value of the marketable asset.

g) **Illiquidity discount** is the excess value of a liquid asset over an asset with a limited liquidity, expressed as a percentage of the value of the liquid asset.

h) **Lack of control discount** is the excess value of an asset incorporating control over an asset with a limited control, expressed as a percentage of the value of the asset incorporating control. (In practice the term "minority discount" is often used).

i) **Control premium** is the excess value of an asset incorporating control over an asset with a limited control, expressed as a percentage of the value of the asset with limited control.

j) **If a discount or premium** that is used in business valuation report is defined otherwise than stated above (for example as the percentage of the total value of equity), it is necessary to include the definition of such a discount or premium in the valuation report.

k) **Base value (of a stock, enterprise, ownership interest)** is the value resulting from the common business valuation methods (as defined in the Czech Valuation Standard: Business Valuation) before the application of discounts and premiums.

l) **Enterprise level discount** is a discount which influences the value of all stocks (interests) evenly regardless the level of control or the volume of the interest. Examples of such factors, that influence the value of all stocks evenly is for example dependence on a key client, dependence on a key person in management, potential liabilities etc.

m) **Shareholder level discount** is a discount that influences only some stocks or ownership interests, i.e. it influences the value of stocks unevenly. As a result a value of an interest differs from the pro-rata enterprise value. Lack of marketability and Illiquidity discount and Lack of control discount are discounts at the shareholder level. Control premium is a premium at the shareholder level.

iii) Application of discounts and premiums and relation to the bases of value

a) The use of discounts and premiums **at the shareholder level** in business valuation depends on the purpose of valuation and the base of value.

b) **Market value of an ownership interest is influenced by the degree of marketability, liquidity and control or potential control inherent to the ownership interest**. The market value is defined in the Czech valuation standards: Business Valuation Standard subparagraph 3.2. „the set of estimated values for which a business or an ownership interest could be exchanged as of date of appraisal between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgably, prudently and without compulsion". The degree of control and marketability (resp. liquidity) not only depends on the volume of voting rights or other stipulations, it also depends on the ownership structure of the company, meaning the distribution of ownership rights among shareholders. For example a minority interest can be very well marketable if there are two other current shareholders who compete for the control of the company. This "potential" control inherent to the minority interest can cause an observable control premium.

c) **Fair value** of an ownership interest can be and might not be influenced by the degree of marketability, liquidity and control. The reasoning why these influences should or should not influence the fair value should be included in the business valuation report. Fair value is defined (CVS: BV subparagraph 3.4.) as: „estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties".

d) **The base of value for valuation purpose of mandatory takeover bids and the right of squeeze-out should be the fair value. For these purposes the fair value should be estimated as pro-rata part of the enterprise value. Enterprise value should be estimated as using generally accepted and generally preferred methods at the time of valuation. No shareholder level discounts are to be used.** The only exception might be if the marketability of the ownership interest is limited by the Articles of Incorporation or other stipulations.

e) **Objectivised value of an ownership interest as defined in CVS: Business Valuation should be determined as the aliquot part of the value of the objectivized value of the enterprise. Objectivised value is defined as "standardized** income value, that could be re-examined by other subjects, which should be determined from the point of view of the domestic person – the owner (or group of owners), unlimitedly liable to taxes; this value should be determined assuming the company is going to operate under the same concept and realistic expectations of the market opportunities, threats and other factors influencing the value of the business".

f) If the valuation seeks the **market value of an ownership interest**, it is necessary to **define the market for the ownership interest and the characteristics of the market**, above all whether the market is organized, who the potential investors might be and how many they could be as well as the liquidity of the market and expected time horizon of the hypothetical transaction. The market value of an ownership interest should respect the market conditions as of date of valuation. It means the market value of an interest should not be a smoothed value but a value corresponding with the possible imbalances at the market.

g) **The use of enterprise level discounts and premiums is not generally recommended** due to insufficient empirical evidence in the Czech Republic and unique background (time and company specific) which results in high variance of empirically observed results abroad. **Preferably other methods should be used to incorporate such influences into the valuation, e.g. adjustment of the factor in the expected income, working with multiple scenarios or a direct estimation of the value of the factor (for example potential liabilities). The valuation should comply with this paragraph mainly if the estimated base of value is the fair value, market value or objectivized value.**

iv) Base value and it's attributes

a) It is necessary to specify at the introduction of a business valuation report **whether the equity value of the company** (enterprise level) or a clearly defined ownership interest is the object of valuation.

b) The valuation report should state **whether an ownership interest is going to be valued directly, indirectly or using both approaches**.

c) The fundamental condition for using a discount or premium is that **the base value does not incorporate factors which need to be incorporated in the valuation**. Therefore, the valuer should **primarily characterize the result of the base value concerning the degree of marketability, liquidity and control.**

d) Marketability, liquidity and control incorporated in the base value **depend on the method of valuation** that has been used for the base valuation and on the input data characteristics. The **valuation should contain an analysis of these characteristics of the base value**. The valuer should decide whether discounts or premiums should be used on the ground of this analysis.

e) If the base valuation has been an outcome of the **income approach** based on the expectation of the controlling shareholder it results in a control value. If it is based on the expected cash flows of minority shareholders, it results in a minority value.

f) If the base valuation has been an outcome of the **market approach** based on the transactions with minority interests or based on the stock prices at a stock exchange it results in a minority value. If the base valuation has been an outcome of the market approach based on the transactions with control interests it results in a control value.

g) If the stock exchange is efficient the stocks might be traded at control level, i.e. there is no difference between the control and minority value of stocks. If the input data for market approach come out of such an efficient market, the result is considered a control value. The valuer is obliged to state, whether and why he assumes an efficient or inefficient market.

h) If the base valuation has been an outcome of the **asset approach** it results in a control value.

v) Estimation of the size of discounts and premiums

a) The range for a discount or premium **should be derived from empirical observations**.

b) When using **empirical studies to estimate the range** of the discount or premium the valuer should choose a study or studies that incorporate conditions the most comparable to the object of valuation situation. The valuer should analyze the input data (e.g. size of the sample, industry characteristics, location), methodology of the studies as well as the time scope of the study; the valuer should make assumptions concerning usability of the study for his specific case or should make necessary amendments that would lead to an increase of the suitability.

c) **Quantitative** (for example regression) **or qualitative models or their combination should be used for the estimation** of the size of the discount or premium within the range that is empirically observed. If more models are used, the valuer must assure that they are inherently consistent. If quantitative methods are applied robustness checks should be run.

d) The valuer should consider **the mutual influence of the marketability (liquidity) and control** and possible distortion of empirical data caused by it. The valuer should try to eliminate the possibility of double input of the same factor in the valuation.

e) When estimating a **marketability discount the valuer should analyze and clearly evaluate factors that are proven to have influence over the marketability**, such as the time horizon of limited liquidity or marketability, ownership interest market characteristics (competition, number of potential investors, listed contra unlisted stocks..), sales, profit and expected CF and their growth and volatility, financial stability, size of the company or transactions costs.

f) A control premium or minority discount should be used primarily for the investment value estimation when the valuer's role is the one of a consultant for one of the parties of transaction. The **control premium is caused and influenced by factors like a subjective value of a specific investor (might include synergies), private benefits of control (minority shareholder protection, monitoring costs, information asymmetry etc.), and characteristics of the market of the ownership interest** (time pressure, monopsonistic power). It is preferred to try to include these factors to the base value for example using the expected cash flows of the specific investor. If this is not possible, the estimation of the premium or discount should contain an analysis and evaluation of these factors.

g) **Control premium and minority discount are related**. If minority discount is calculated from a control premium or vice versa, the **valuation report should contain the formula of conversion and the calculation**.

6) Comments on the standard proposal

I have selected a few articles of the proposal that I would like to comment on.

Article 3.4. states: "Base of value for valuation purpose of mandatory takeover bids and the right of squeeze-out should be the fair value……" At the moment there is a dispute or rather uncertainty in the Czech Republic which base of value should be used for these purposes. Usually it is stated in the valuation reports, that the value adequate for minority shareholders is the aliquot part of the enterprise market value. So the base of value is being avoided in this way. The reason is that the Czech law says that the minority shareholders have the right of receiving or being offered an adequate consideration for their stocks but the law does not continue what should be considered "adequate consideration". In practice it used to cause many problems. Therefore the Czech National Bank as the body of supervision over the listed companies stated that the adequate consideration should be calculated as the aliquot part of the market enterprise value. I have witnessed a few lawsuits where the minority shareholders require fair value base of value instead the market value or the value derived in the way stated by the CNB. But then we arrived to another problem: how to calculate the fair value? Fair value as defined in the IVS (or by the Czech BVS) does not unequivocally state how technically the value should be derived. The judges are not capable to decide about that because they do not have economic and valuation background and the appointed valuer should not be left alone deciding and defending about what is "fair" or adequate. Even the Supreme Court ruled that the appointed valuer's role is not to decide about that. Therefore I feel it should be a thing to be solved by the valuation standards. This article of the proposal is based partially on the Czech prevailing practice, the instructions of the CNB and we have found support in Model Business Corporation Act, Section 13 (ABA, 2009) where „fair value" calculation for the same purposes is described.

Concerning article 3.5. Objectivized value is a base of value coming from the German standards. It is being used in the Czech Republic too. It might be a more suitable base of value in cases where market evidence about the prices is missing or the market is not efficient and in the same time in case the valuation is searching the most "objectivity" possible.

Concerning article 3.6. The market value has been misunderstood in the Czech Republic by some users mostly as some model value when the market is in equilibrium. Therefore I believe it is necessary in case of discounts and premiums to emphasize the influence of market imbalances on the market value of ownership interests.

Concerning chapter 5 Estimation of the size of discounts and premiums is focused on a more detailed methodology. The reason is that many valuation reports fail to estimate the discounts or premiums in a transparent, repeatable and complex way or use inconsistent methods or models.

7) Implications

The research underlying this paper was not focused on collecting primary data and statistics resulting in new outcomes. Nevertheless it was focused on looking for the various existing practices and their positive as well as negative implications in the context of theoretical economic and legal background. It resulted in determining the most recommendable way, let us say the recommended "best practice" in application of discounts and premiums in business valuation that could be accepted by all interested parties in the Czech Republic. The interested parties are many: courts and police, the Czech National Bank, the investors and last but not least the business valuers themselves.

The courts and police are one of the most important users of business valuation reports and currently since business valuations standardization is missing it multiplies the time and costs needed to decide or solve the cases since there is a big variance in the valuation results and no professional unity in the valuation approaches in the field of discounts and premiums. The standard should help to lower the time and costs needed to close the cases.

The Czech National Bank as the supervision body over the valuation reports in some cases of acquisitions of traded companies would have a clear, public and transparent way based on the standard to evaluate the valuation reports. In the same time, the recognition of the standards by the Czech National Bank would help the standards to be generally accepted.

The investors as the bodies who order the valuations and bear the costs by paying for the valuation reports are offered (in the form of the standard) a tool to be able to assess the quality of business valuation reports and to know what to demand (what to order) from the business valuer as far as the necessary analysis or underlying data are concerned (for example). The standards if they are accepted should make the Czech business environment more predictable and thus less risky. Since there are many multinational companies in the Czech Republic, the standards should as well help to harmonize the international business environment.

For the business valuers themselves the benefits of the standardization should be significant. The great portion of uncertainty that is now lying as a burden on each individual valuer should be removed. The standrads should show the prevailing professional opinion in areas of dispute. Therefore the valuer (especially as a court witness) would hold a strong position and would have argumentation strength. Besides, the standard should give the valuers a clear lead about the structure of the valuation report, the extent of necessary analysis and usable methodology etc.

The standard proposal has been prepared as a starting point for further professional discussion over the topic and cooperation among all these interested bodies. The standard proposal should be publically discussed and amended before it is accepted. We find preferable the form of standard as opposed to the form of a legal norm since it is the more flexible way, it is prepared and influenced strongly by professionals and interested parties as mentioned above and not politicians.

We welcome any comments and suggestions or exchange of experience from the business valuation standardization field from other countries.

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Acknowledgement

The paper was written as one of the outcomes of research project of the Faculty of Finance and Accounting at the Universiy of Economics Prague, which was funded by institutional support number VSE IP100040.