KPMG

Top Management Quarterly August 2005

Horizons

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Managing Partner
KPMG Czech Republic

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Editorial

Václav Baňka
Partner, Tax Services

The Czech Republic in the European Union (EU) – tax hindsight

As a result of the accession of the Czech Republic to the European Union, tax regulations governing indirect taxation have changed significantly. Czech companies have been, after a period of hectic preparation before accession (1 May 2004), familiarising themselves with the new regulations and procedures governing this area. The Ministry of Finance adopted a broad-minded approach to the collection of penalties for 2004, but tax inspections for 2005 will be carried out as required, with zero tolerance. The increasing volume of goods and services supplied to the European Union and third countries is accompanied by an increasing volume of payments in relation to which output VAT need not be applied/paid. This approach cannot be applied automatically to all situations where the customer or the buyer is a foreign entity. Non-application of VAT needs to be considered carefully and supported by documents that prove the entitlement to use this approach during tax inspections. Additionally assessed tax and penalties can be very high since indirect taxes are transferable and the same mistake usually applies to each supply of goods. Internal processes and accounting systems which may prevent these mistakes need to be set up correctly.

EU tax regulations have not changed significantly over the last year. Indirect taxes have been considerably harmonised and the legislation and administration of taxes (introduction of one-stop-shop system) is being simplified. This system would enable VAT payers who have taxable supplies in various member states to register for tax and file tax returns only in the member state of residence. Information from the single tax return would be distributed to relevant member states in which the taxable supplies were effected. As regards direct taxes, the most important changes lie in the Directive on Taxation of Savings Income, which became effective on 1 July 2005, and the amendment of the Merger Directed, which became effective in February 2005 and relates to European Society Company. Regulation and determination of the amount of direct taxes remains in the competence of individual member states, and direct taxation may become a competitive advantage of certain member states. The trend to reduce the corporate income tax rate started in the new member states has been witnessed in the traditional member states (such as Germany, Austria and the Netherlands). The widely discussed European Constitution did not reverse this trend. It would have introduced an implementation of the amended decision-making procedure in the

"EU tax regulations have not changed significantly over the last year."

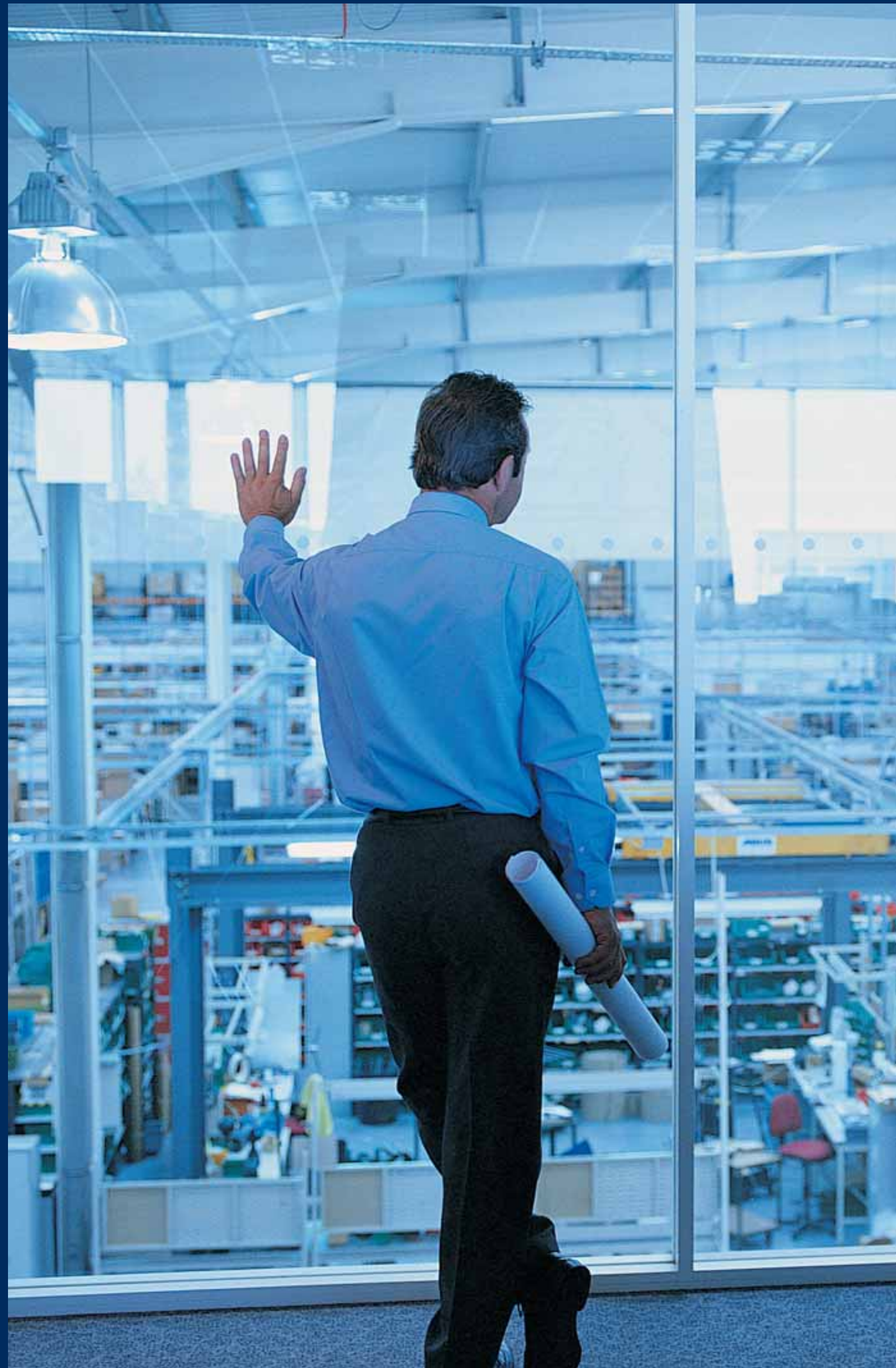
Council of Ministers (certain types of legal acts would not have required the unanimous consensus of all member states but could have been adopted by a qualified majority). In the fiscal area, a qualified majority would only be applied to customs matters, whereas other taxes would still require the unanimous consensus of all member states represented in the Council of Ministers.

EU member states began to simplify indirect taxation more than 10 years ago and this trend will probably continue in the near future. EU tax policy will probably not change significantly. No significant reforms of direct taxation are expected, EU member states are not willing to harmonise tax systems and EU bodies do not have the powers and competence (and the adoption of the existing wording of the European Convention would not change this) to enforce harmonising amendments without the approval of the member states.

Václav Barta

Quality of internal audit and its assessment

Accession of the Czech Republic to the European Union (EU), market globalisation and the increasingly competitive environment have boosted the activity of foreign investors who require stricter standards of accountability, conduct and performance. Companies seeking foreign capital are coming under increasing pressure from foreign investors and only those companies that meet international standards of corporate governance (functional internal audit being an inherent part) can succeed.



Internal audit (IA) could potentially become one of the crucial services provided to management and supervisory bodies for their decision-making and as such, can bring added value to the whole company. Internal audit not only provides services to top management, members of the management, supervisory bodies and to the audit committee, it is also a major driver of improvements to the company's risk management system.

Why assess internal audit?

There are several reasons why the performance of internal audit should be assessed. One of them is the regulation of the Czech National Bank governing assessment of the performance of internal audit within banking institutions. The Czech Securities Commission and public administration have also issued regulations requiring creation of an internal audit department and relating to assessment of the performance of the internal auditors. Yet none of these regulations defines that the internal audit is an inherent part of corporate governance and must function effectively. Internal audit can be assessed from various points of view which differ according to the recipient of the provided services.

KPMG International has developed a methodology that describes the basic assessment criteria. These criteria are used when comparing the results to the results of major European companies and to determine the position of individual internal audit departments. The key criteria are how to assess internal audit and how to define its added value.

How to assess internal audit?

The assessment of internal audit focuses on three basic issues – positioning of the internal audit department, human resources and processes.

1. Positioning of the internal audit department

- Does the company need an internal audit department?
- Is there a departmental structure and a strategy?
- Does the internal audit department have a strategy?
- Who are its customers?
- What services does it provide?
- How is it financed?
- Are there any criteria for assessing the internal audit department?

Does the company need an internal audit department?

We assess the role of the internal audit department in the company, its integration into the overall structure and its independence. We also review whether the role of the internal audit department is defined clearly and communicated effectively.

- Has a departmental charter been approved?

- Are internal audit services available to all levels of management?
- Is the management of the internal audit department in regular contact with the wider management and members of the board of directors? Does he inform them about the planning of engagements and audit results?
- Is there cooperation with subsidiaries?
- Is there established cooperation with the risk management department?

Is there a departmental structure and a strategy?

A departmental structure encourages objectivity, consistency and understating of the company's business; the departmental strategy is defined in relation to the structure.

- The head of internal audit is usually directly accountable to the CEO and is subordinated to the audit committee, which approves the department's statutes, plans and budgets and the salary of the head of the department.

Who are the customers of the internal audit department and what services does it provide?

We review whether the services of the internal audit department have been approved by the statutory bodies, reflect the needs of the company and whether the customers are clearly defined.

- Is the internal audit function consistent with management requirements?
- What do the customers of the internal audit department think of its staff?
- Are they a benefit and are they perceived as advisors or rather as "watchdogs"?
- Do the customers understand the nature of the work of the internal audit department and the scope of its services?
- Does the management value the outputs (what assistance and support is provided to internal audit)?

How is it financed?

We determine whether the provided funding ensures objectivity and a consistent quality of service across the company.

- The allocation of funds must not inhibit objectivity.

Are there any criteria for assessing the internal audit department?

The performance of the internal audit department is regularly reviewed by the audit committee and the company's management based on the success criteria.

- Feedback from the users of the reports on audited customers.
- Analysis of time spent on audits, other projects, training, etc.
- Average length of time from the start of the audit until the audit report is issued.
- Efficiency.
- Effectiveness.
- Staff qualifications.
- Anonymous survey.

2. Human resources

- Powers and responsibilities.
- Human resources strategy.
- Career development.
- Culture.
- Evaluation, remuneration.

Powers and responsibilities

- The key powers and responsibilities of the internal audit department are defined in relation to its function and objectives. This is in accordance with the strategic plan of the department on which the human resource strategy is based.
- Concept reflects internal audit function and role.
- Depend on the phase of the transformation process from a traditional approach to a risk-based approach.
- Specialisation.

Human resources strategy

- The need to balance key permanent staff with rotating or new dynamic staff in order to optimise the overall potential with the aim of achieving quality and effectiveness.
- Human resources strategy influences the way the management, customers and external auditors perceive the internal audit department.
- Knowledge of foreign languages in international companies.

Career development

- Training corresponding to powers and responsibilities.
- Structuring, individual approach to career management.
- Does every employee in the internal audit department have the opportunity for career growth?

Culture

- Does the internal audit department contribute to good working relations and does it contribute to achieving the company's mission?
- Utilisation of working hours, dress code, representation, reputation.

Evaluation, remuneration

- Are the remuneration principles in accordance with the company's standards and are they transparent for the staff?
- Do they include aspects linked to performance?

"One of the key criteria for the success of the internal audit department is the relationship between the measures recommended by the internal audit department and the measures adopted by the management and implemented."

Having a defined process is a fundamental criterion for assessment of the quality of the internal audit department.

3. Processes

- Planning.
- Technology.
- Management, infrastructure and support.
- Performance measurement and evaluation.
- Relations with managing bodies.

Planning

Does the internal audit department have a proper planning methodology and does it provide high-quality services?

- Participation in the planning process.
- Independence.
- Risk based audit planning.
- Annual plan.
- Extraordinary audits.
- Communication with customers.
- Audit committee.
- Capacities.

Technology

- Use of technologies which increase the quality of services provided by the internal audit department.
- Audit software.
- Staff training.

Management, infrastructure and support

- Administrative processes which ensure smooth operation.
- Monitoring of time spent on an engagement, budget management (expenses vs. budget).
- Scheduling of staff for various projects and ensuring their effective use.

Performance measurement and evaluation

- Is the performance of individuals measured against internal audit objectives?

Relations with managing bodies

- Does the internal audit department develop and manage good relations with key internal audit users?

Any and all activities of the internal audit department should have significance within the company; as such, the internal audit department should be assessed based on added value.

Added value of the internal audit department

How do we define the added value of the internal audit department? Can we measure it? It is difficult to answer these questions, although the benefits of high quality internal audit are obvious. When quantifying the benefits of internal audit, both short-term and long-term results need to be taken into account.

Recommendations for addressing lost revenues, unnecessary expenses, poorly managed projects and insufficient or incorrect management information for decision-making are all examples of added value that the internal audit department can bring to the company.

One of the key criteria for the success of the internal audit department is the relationship between the measures recommended by the internal audit department and the measures adopted by the management and implemented. This indicator, together with the feedback provided by individual managers, shows how the management perceives the value of the measures proposed. The reputation of internal audit and the partnerships it establishes with other departments also reflect its position in the company..

Conclusion

The described approach to the assessment of the internal audit department is based on the assumption that the internal audit is operational and that the management and supervisory bodies fully accept its integration into the overall corporate governance framework. The corporate governance survey published recently by KPMG Czech Republic showed a surprisingly low use of internal audit services by supervisory boards. Almost 41 percent of the respondents stated that the supervisory board does not use the services of the internal audit department at all. In addition 30 percent of the respondents have no knowledge of its activities, which can only be explained by the fact that these respondents neither manage the internal audit department nor use its services. It is encouraging that most members of the board of directors and supervisory boards are informed about the activities of the internal audit by means of a regular report; but there still is a great deal of room for improvement as we integrate into the European markets.

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Audit

The European company

One of the rising stars on the European law scene is the European company (Societas Europaea).

Legal definition

The entity "The European company" was established by an EC Regulation on 8 October 2001. This Regulation became effective on 8 October 2004 and from that day onwards all EU member states have had to provide for the establishment of European companies. The Regulation is complemented by an EC Directive setting down rules for the involvement of employees in a European company. The Czech Republic implemented these regulations later, taking effect from 14 December 2004.

"The European company is not a substitute for existing national legal forms of business companies; it is a legal form which should enable for the first time a single entity to operate throughout the territories of the European Union (EU)."

The European company is a type of joint-stock company. The Regulations set minimum subscribed capital at EUR 120 000; however, it is at the discretion of member states to increase the requirement of the minimum subscribed capital. The Czech Republic did not opt, taking into account lower requirements relating to domestic joint stock companies (CZK two million), to apply this provision. The European company is recorded in the register of companies in the country of establishment and the official abbreviation is SE (Societas Europaea).

The European company is not a substitute for existing national legal forms of business companies; it is a legal form which should enable for the first time a single entity to operate throughout the territories of the European Union (EU). Its aim is to facilitate the consolidation of companies within one business group operating across many different member states, enable cross-border mergers, and allow transfer of the registered office from one member state to another. The ways of establishing the SE reflect the aim.

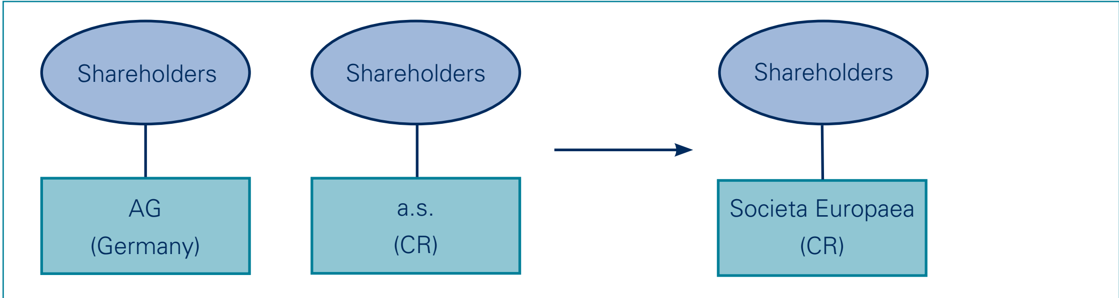
Ways of establishing the SE

The European company may be established:

- by means of a merger
- as a holding company through the contributions of shares/ownership interests
- as a subsidiary
- by means of a change of legal form.

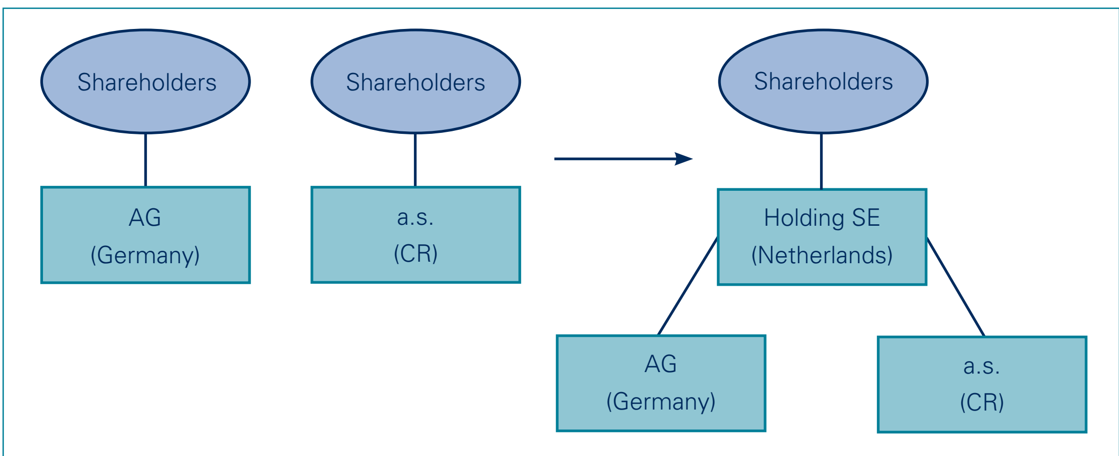
Merger

The merger requires the involvement of joint stock companies from at least two different member states. The merger can take two forms: combination (one of the participating companies becomes the successor company) or consolidation (a new company is established).



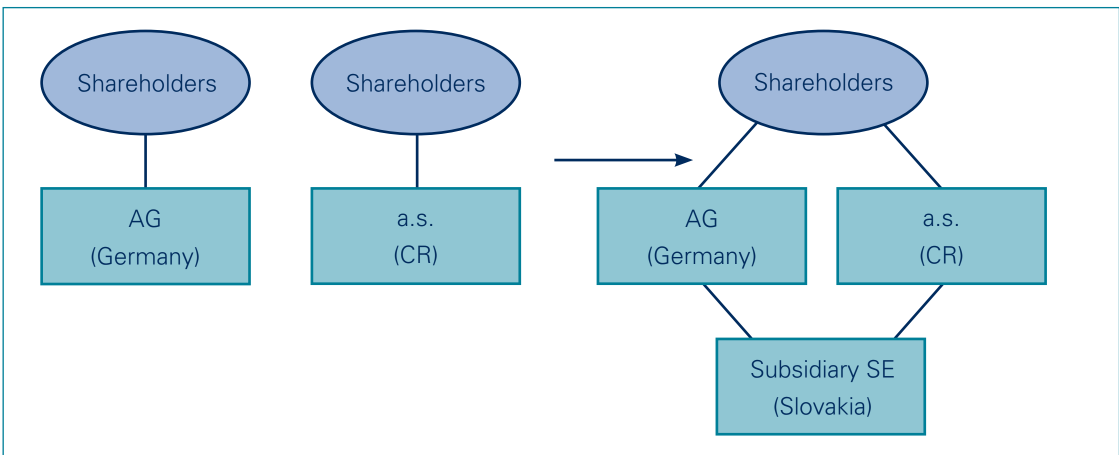
Establishment of a holding SE

The European company may be established as a holding company by means of the contribution of shares/ownership interest in a joint-stock company or in a limited liability company, provided these companies have their registered offices in at least two different member states, or in one member state but have had a branch or subsidiary in another member state for at least two years.



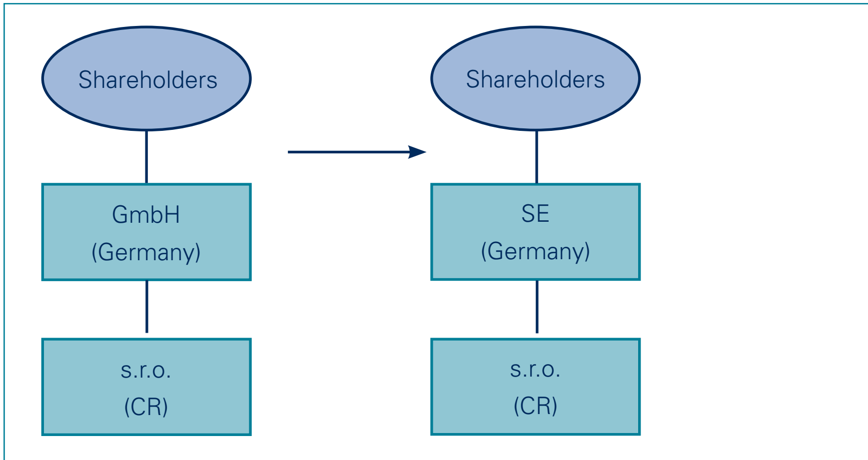
Establishment of a subsidiary SE

Two companies that have a registered office in at least two member states, or companies from one member state which have had a branch or subsidiary in another member state for at least two years, may establish a subsidiary SE.



Change of legal form

The European company may be established by the conversion of an existing limited liability company, provided it has had a subsidiary in a different member state for at least two years.



Tax implications

There is no specific tax regulation governing European companies. The same regulations apply to them as to the national companies which operate in different member states through subsidiaries or branches. A provision of s. 37a of the Czech Income Tax Act states that the SE shall compute its tax base, tax loss and tax liability and shall proceed in tax proceedings in a similar way to a joint stock company.

The idea of the SE is not to restrict the right to pay tax in the source member state to the benefit of the member state in which the company has its registered office. Nevertheless, the issues of permanent establishment, taxation of dividends and transfer pricing still needs to be addressed.

The SE offers, depending on national tax regulations, interesting possibilities for planning and optimisation, such as:

- a more advantageous double taxation prevention method (offset as opposed to exemption)
- possibility of utilising the tax losses of a permanent establishment
- elimination of withholding tax on dividends, licence fees or interest
- elimination of issues relating to thin capitalisation
- elimination of issues relating to the specific regulation of taxation of subsidiaries as opposed to jurisdictions with low taxation (i.e. CFC regimes).

"The decision to establish the European company should be preceded by a detailed analysis of all strengths and weaknesses from the point of view of participating entities, their shareholders and the established entity. Although related tax regulations still lag behind regulations providing for the European company, this legal form might be the right alternative for some businesses."

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Tax Services

Regulation of greenhouse gas emissions – business opportunities and risks

Companies operating in the energy, metallurgical, chemical and other industries are facing challenges arising from the regulation of greenhouse gas emissions. Will they fulfil the new requirements or will they have to make significant changes to their production processes?

"The key strategic decision for a company is whether to continue increasing greenhouse gas emissions or to change its production processes so that they do not generate emissions."

Why was the legal regulation of greenhouse gas emissions adopted?

As a result of scientific evidence that increased emissions of greenhouse gases are causing global warming, the Kyoto protocol was drafted. The member states of the European Union (EU) adopted the principles set out in the protocol and even define more detailed limits for greenhouse gas emissions.

The short-term aim of the regulation is to mitigate the drastic rise of greenhouse gas emissions into the atmosphere and to mitigate the potential consequences such as the melting of icebergs and glaciers and the rise in the sea level worldwide. In the long-run, the regulation is aimed at stopping emissions and ultimately reducing the volume of greenhouse gases in the atmosphere.

How does the regulation system work?

The current system of regulation of greenhouse gas emissions results from the obligation of regulated companies to surrender one allowance for one ton of CO_2 emissions. The allowances are granted to the regulated companies once a year in accordance with the National Allocation Plan (NAP) which is approved for a trading period. The first trading period runs for three years and begins in 2005, subsequent trading periods will be five-year periods. The aim of the first trading period is to embed the regulatory and trading system of allowances.

The obligation to surrender allowances is reinforced by a system of sanctions which imposes fines for failing to fulfil the statutory obligations.

The aim of regulation is to limit the overall volume of CO_2 emissions that can be emitted within the relevant territory. The regulated companies may trade allowances so that the regulatory function follows market principles: the price for a single allowance and the permitted level of greenhouse gas emissions are set and allow an environmental area to be treated economically.

In the subsequent trading periods the companies will be obliged to gradually reduce the production causing greenhouse gas emissions which will be achieved by gradually reducing the number of allowances in accordance with NAP. The companies will have to respond by reducing production, converting to "clean" production methods (production with reduced greenhouse gas emissions), purchasing allowances from other companies or any combination of individual options. Allowances will be available on the market from the surpluses or savings of other companies.

How many allowances and to whom?

The method of allowances allocation is one of the key aspects for the success of the companies in the entire system. Companies need to know how many allowances they will receive and compare this with their current and future business. They also want to know how many allowances their Czech and foreign competitors will receive. The number of allocated allowances in individual EU member states is determined based on the data in the relevant NAP. The "starting" level is allocated free of charge, additional allowances can be bought at the market price.

"It is certain that in particular during the first trading period in which the regulatory system for emissions will be set, the risks will outweigh the opportunities."

Today many companies, in particular in the original EU member states, are forced to find an appropriate response to the regulation as their permitted "starting" levels do not cover their existing production. The companies in the new member states need not necessarily get into the same situation, despite the recent reduction in the number of allowances issued by the EU under the NAP which also affects CEE countries (Czech Republic, Poland and Slovakia).

What will the regulation of greenhouse gases mean for the affected companies?

Companies will have to adjust their corporate strategies to be able to respond to the requirements and to keep within the emission limits set in the relevant NAP. Changes in corporate strategies require alterations to other corporate processes (production and investment decision-making, controlling and reporting, risk management). The accounting and tax implications also require a specific approach.

The key strategic decision for a company is whether to continue increasing greenhouse gas emissions or to change its production processes so that they do not generate emissions. This has direct implications for investment decision-making – deciding which technologies and production capacities to invest in and how much to invest. The value of existing and future investments should be based on ordinary (ceteris paribus) planned expenses and revenues from the investment and expenses and revenues related to the regulation of greenhouse gas emissions.

A new approach is required to the accounting and tax implications of allowances. New transactions need to be recorded in the accounting system (allocation of allowances; creation and release of provisions for emissions into the atmosphere; value and revaluation of allowances; surrender, purchase and sale of allowances) some of which have direct tax implications for companies.

The implementation of control and reporting functions in relation to greenhouse gas emissions will have an impact on a company's ordinary operations. The management will be able to make decisions based on relevant and complete information and to consider which products are the most demanding in terms of emissions and their fair value. Specific performance indicators will enable detailed monitoring to the level of the individual product margins.

Companies that manage their risks should focus on cataloguing the risks related to the regulation of emissions, their definition and quantification. The risks are two-fold: business and operating, both of which may have

a significant impact on the production and profitability of products, the production of which results in the emission of greenhouse gases. The importance of these products in the product portfolio determines the significance of the risks for the operations of the company.

More risks or more opportunities?

In addition, regulated companies face risks related to insufficient or incomplete preparation for the new regulatory requirements. One of the less significant risks is inadequate implementation of the regulation into the company's corporate processes, inhibiting correct monitoring of product costs which may result in distortion of the product selection criteria. Lagging behind competitors who prepared better for the regulation and can now exploit a competitive advantage in the market is another possible risk.

A major risk with a direct impact on the cash-flow and production capacities of the company is the failure to use the appropriate number of allowances (corresponding to the volume of emitted greenhouse gases) in the required period, or failure to meet other regulatory requirements. Companies that fail to fulfil the requirements will have to pay high fines, in particular for the late use of allowances.

The fact that the company has paid a fine does not release it from the obligation to meet the regulatory requirements. This could have an impact on the cash-flow and serious implications for the production capacities of the company, which would be forced to reduce the volume of production in order not to exceed the emission limits corresponding to the number of allocated allowances. An unplanned reduction in production could negatively affect product margins with the resulting impact on the company's break-even point and possible loss of market share. Investments in production capacities may also be lost.

The company may profit from the allowances existence if it manages to reduce its emissions and to sell the spare allowances. The temporary sale of allowances on the market represents an opportunity to generate short and medium-term funding. Experience from abroad shows that allowances can also be used in marketing – they may be sold together with raw materials, the processing of which is connected with the emission of greenhouse gases. Last but not least is the opportunity to get ahead of competitors by carrying out proper and timely preparation for the regulation of greenhouse gas emissions.

It is certain that in particular during the first trading period in which the regulatory system for emissions will be set, the risks will outweigh the opportunities. The defence against the risks and the first step towards exploiting the opportunities should be thorough preparation for meeting the regulatory requirements, consisting of a direct response to the regulatory requirements, putting in place internal processes enabling the optimum sharing and assessment of information within the company and subsequent decision-making related to corporate strategy and investments.

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Risk Advisory Services

Public administration in Europe

The member states of the European Union (EU) are looking for ways to improve public service quality. Their common objective is to increase the capital and financial power of the states, regions and municipalities. The capital power of the state (region, municipality) means the proprietary and moral strength of the stakeholders and their ability to take care of public and private capital. Their financial strength is determined by their readiness to invest to expand their property and to grow spiritually.

"Public administration has specific managerial requirements. The administrative hierarchy of the Union, state, region or municipality allocates responsibilities over each activity of the life cycle of strategies, programmes, projects and activities."

The current need of all governments, not only in the European area, is to support public funds from private funds, to boost the partnership of both sectors, to strengthen the non-profit sector and to achieve the goal-directed involvement of government, regional and municipal stakeholders. The terms national, regional and municipal government are used in this context.

The public government is responsible for the management of the common property of stakeholders, i.e. all parties who are concerned with public administration. The government manages economic, social, security and environmental issues on behalf of public finance. There are several management approaches:

- pragmatic (direct public administration focused on management principles)
- ideological (direct public administration focused on principles of political power)
- non directed public administration mediated by private sector
- non directed public administration mediated by public sector.

Governments in the European area are not owners but administrators who provide public services and manage the public sector by means of public budgets. Public budgets revenues and expenses are realised on the territory of the Union, states, regions and municipalities in the set legislative and institutional framework. The European Commission has been harmonising the techniques and technologies of government governance in the European area.

Manager in public administration

Public administration employs politicians and public institutions officers. These are two different groups – politicians and professionals. Politicians determine the main direction of the government, usually in accordance with the opinion of the majority of stakeholders (in the country, region or municipality). Professionals are subdivided into officers (traditional) and managers (a newly established position). Politicians, officers and managers are integrated into a hierarchical structure; they are subordinated to their respective managers and have their own subordinates.

The task of the politician is to enforce the political (strategic) will of the voters he represents. He is politically accountable for the quality of government and its implications in the state, region or municipality. There are usually three levels in which a politician may carry out his mission: coalition, opposition and independent position. His term in the public administration structures reflects the election cycles which differ at national and local

self-government level. The demanding work of a politician requires systematic education; its focus should be the application of a strategic vision and its output is the quality of the position of an individual (of the municipal or regional community) in a national or EU context.

Officers work within the set processes (of an authority or institutions) and carry out the tasks in accordance with the received political (strategic) objectives within the given legislative and institutional framework. They are in direct contact with citizens and the beneficiaries of public services. Their responsibility requires adequate education (education of public administration officers). Officers are employees of public authorities or organisations and work within the rules defined by laws, regulations (primary legislation) and resolutions and decrees (secondary legislation) and internal guidelines and instruction in the office (tertiary legislation). The focus is on services to citizens and the output is high quality public administration.

Managers are a new element in the public administration. Their responsibility is to ensure proper functioning of the office, financial support to and actual provision of public services (financial management, audit and review of processes of the defined roles). Managers carry out tasks in accordance with approved political (strategic) objectives, cooperate with officers and have managerial responsibility in capital, financial, economic, technical and organisational issues. They are responsible for the effective, and efficient economy provision of public services; they order transactions in individual sectors, such as transport, health care, education, communal waste, etc., on the territory of the state, region or municipality. Such managerial tasks require education (education of public administration managers). We can find managers in central government offices, at ministries and at regional or municipal authorities. The focus is on services to public administration and the output is a functional competitive public administration.

Politicians, officers and public administration managers have their own hierarchical system – they are organised in departments, division and groups and have their own network of managers. These relations are governed separately, for example by the Act on Public Service. The work of politicians, officer and managers is defined by set processes, described in the relating decrees and regulations (i.e. relevant secondary and tertiary legislation).

Requirements on politicians, officers and public administration managers

Stakeholders change their requirements and the principles of government become stricter and more demanding. Public administration has ceased to be perceived as an instrument of executive power and is now regarded as a service to citizens. This is why managers were introduced in the public administration sector; they are not just a new component of public administration, they constitute the bridge between managerial, audit and review mechanisms of public and private sectors.

The education of politicians, officers and managers has its specifics. Universities distinguish between the positions of public administration workers quite sensitively and concentrate on adequate general

knowledge, but there are no materials for the preparation and realisation of educational and retraining courses for politicians, officers and managers which would reflect the reality of the provision of public services (transport, health care, education, communal waste).

The interest of the stakeholders, in the broadest sense, is to support the growth of the qualifications of politicians, officers and managers and to enable them free access to the European labour market. EU invests a lot of funds into education of these positions and endeavours to adopt and provide for four value pillars of European public administration:

- reliability
- anticipation
- responsibility and
- transparency.

Good public administration is based on the harmonisation of individual process (planning, management, control, monitoring, audit, reporting) between different states, regions and municipalities. The aim of this harmonisation is to incorporate the following general principles of best governance into the four value pillars:

- objectivity and impartiality (fairness, justice) in decision making
- prohibition of discrimination (equal treatment) in decision making processes
- respect of proportionality and adequacy
- elimination of precipitation and superficiality
- support of transparency
- conclusions are not forced but reached by consensus.

Value pillars and decision-making principles in public administration concern the cycle of personal responsibility of public administration staff.

The cycle of responsibility means a complete chain of decisions of a politician, officer or manager as defined by their respective responsibilities.

To fulfil and to close the public sectors cycles of responsibility is a demanding managerial task, comparable to the governance and management of big supranational holding companies.

Public administration has specific managerial requirements. The administrative hierarchy of the Union, state, region or municipality allocates responsibilities over each activity of the life cycle of strategies, programmes, projects and activities. This hierarchy is provided for in primary legislation (usually in the act on powers and authorities and other related acts) and described in detail in secondary legislation in respect of individual segments of services (in decrees governing transport, health care, education and communal waste) and in tertiary legislation governing the regulation of the functions of individual bodies and institutions of central public administration and local self-government.

Conclusion

Governance will not be competitive unless the labour market of professionals will fully develop also in the public sector. The ability to govern at a union, national, regional or municipal level requires the international cooperation of the OECD countries in approving internationally accepted standards and transferring good practice of governance and management of private and public entities. Convergence of corporate governance and government governance is an inevitable reality. Educating politicians, public administration officers and managers may help to fully develop this portion of the labour market also in the Czech Republic.

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Risk Advisory Services

Definiton of "value" in business valuation

We often come across the general term "market value", however, the term is actually highly ambiguous and gives no indication of the specific value determined in the valuation process. Often, it is difficult to establish to what extent the valuation is appropriate, from the point of view of methodology and the assumptions on which it is based. The Czech Commercial Code does not help as it does not provide any more detailed definition of "value". This can have serious implications.

The financial literature dealing with valuations provides many phrases containing the word value: fair market value, market value, fair value, true value, investment value, intrinsic value, fundamental value, insurance value, book value, value in use or collateral value, some of which are based on different criteria.

The English technical literature differentiates between the following categories[1]:

1. owner value (also economic value or intrinsic value)
2. market value
3. fair value.

Owner value

The owner value is defined as the value of an asset to the current or prospective owner. The owner value for the current owner is the amount of compensation he would receive for giving up the ownership rights (and the value) of the relevant asset. The owner value for the prospective owner is the economic value of business opportunities arising from the acquisition of the asset with any attaching conditions (through using his own sales network, broadening the product portfolio, or creating other synergic effects).

It is obvious that these two values will differ since they are determined based on different strategic and business assumptions and the opposing positions of the seller and the buyer. The assumption for undertaking the transaction is that the value for the buyer exceeds the value for the seller. In practice this may happen only when the transaction brings some synergic effect or creates added value for the buyer. The owner value does not necessarily correspond to the market value.

Market value

The term market value is an estimate of the price for which the asset could reasonably be exchanged on a free market to which investors have access. The seller and the buyer are assumed to be aware of the conditions of the exchanged asset and the market conditions in general, each acting in their own interest. The assumption is that the buyer has no specific interest in the purchase, or if he does, the interest is publicly known. The transaction should also be carried out within a reasonable timescale.

Fair value

The fair value is the same for both the seller and the buyer and is used where neither the buyer nor the seller has access to the free market. Fair value may be used, for example, when a transaction is carried out based on a contract (Memorandum of Association, Articles of Association) which sets out the procedure for the transfer of the asset between the parties. There is no general definition of fair value; the valuer should consider the position of both parties equally.

The key factor when deciding whether to use the fair market value or the fair value is whether the parties to the transaction have access to the free (and liquid) market to check the correctness of the value.

The Czech Commercial Code requires a value to be determined for many transactions: sale or purchase of an enterprise or its part, participating interests in a legal entity mergers and other types of business transformation, non-monetary contributions to the registered capital of a company, determination of appropriate compensation in the case of take-over bids or buy-out of minority shareholders. Other situations that are not provided for in the Commercial Code would also require definition of the value, for the purposes of court proceedings, support for management decisions or as required by statutory or contractual provisions. When requesting a valuation, it is necessary to determine which type of valuation is required.

Too much emphasis is often placed on determining the market value. Usually, the estimated value is just the starting point for price negotiations between the relevant parties.

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[1] Business valuations, ICAEW 1994, no. 6

KPMG Czech Republic

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Printed in the Czech Republic

Horizons August 2005