

## A REVIEW OF THE REPORT ON RELATIONS BETWEEN THE CONTROLLING AND CONTROLLED PARTY AND BETWEEN THE CONTROLLED PARTY AND PARTIES CONTROLLED BY THE SAME CONTROLLING PARTY

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**Abstract:** The identification of relations between legal entities is not always simple. In regard to a controlling and controlled party such a situation can arise in which the controlled party or the third party (a minority owner of the controlled party) suffers injury by a conduct of the controlling party. The aim of this article is to review the report on relations between the controlling and controlled party. The content of the Report on Relations is examined in relation to complying with the legislation under Act No. 89/2012 Sb. the Civil Code and Business Corporations Act No. 90/2012 Sb. Real doubts about a correct identification of controlling and controlled parties together with other slight formal flaws were identified. Neither the infliction of injury on the controlled party, nor on the minor owner was found.

**Keywords:** review, the report on relations, legal entities, group of companies, legislation, the usual price, reasonable consideration.

### 1 Introduction

The legislation governs legal relations between the controlling and controlled party – Business Corporations Act No. 90/2012 Sb., and Act No. 89/2012 Sb., the Civil Code in particular. Provided a review whether these stipulated relations are observed is asked for, there are several methods that can be followed.

What is thereby to be dealt with are relations between legal entities. Act No. 89/2012 refers to legal entities as organized departments that obtain legal nature awarded by law or whose legal nature is recognized by law (Bezouška, Piechowiczová, 2013). Vít (2015) states that a legal entity is a legal fiction which does not actually exist and which can be formed, dissolved or changed only under the law. Pursuant to S. 118 Act No. 89/2012 Sb., the legal entity obtains its legal nature from its formation to its dissolution (Czech Republic, 2012a).

The controlling party refers to a party which actually or legally directly or indirectly decisively influences the administration or operation of the corporation of the controlled party (Ryneš, 2018). Under S. 74 (1) Act No. 90/2012 Sb. the controlled party refers to a business corporation that is controlled by a controlling party (Czech Republic, 2012b). Ryneš (2018) says that if one or more corporations that are subject to uniform administration are to be dealt with, these are referred to as a group of companies.

A legal relationship refers to a corporate relationship of more subjects that have mutual rights and obligations. Legal relationships are bilateral or multilateral. We distinguish two legal relationships: relative (correlative relationships on the part of both – the entitled and the obligated party) and absolute (one subject has absolute rights or obligations and this right applies to the obligation of non-specified number of subjects) (Knapp, 1995).

The injury to the controlled party or another involved party may be caused by the conduct of the controlling party. The injury may be financial or non-financial. For example, financial injury may be caused by inadequate financial performance for contracted services. The controlled corporation then suffers non-financial injury such as damage to its reputation even in the event of unintentional fault of the controlling party.

### 2 Literary research

It is a report on relations that must be annually submitted by all controlling parties. The report contains information on relations

between the controlling party and controlled party or parties. Its wording and elements are regulated pursuant to S. 82 Act No. 90/2012 Sb (Czech Republic, 2012b).

Under S. 82 (1) Act No. 90/2012 BCA the report must be produced within three months after the deadline of the accounting period. The report of relations is drawn up in order to inform partners of the group of companies. Under Sec 84 (1) Act No. 90/2012 Sb. controlled parties are entitled to get acquainted with the report on relations within same time limit and under same conditions as they were with the financial statement at the most recent session of the supreme body (Czech Republic, 2012b). In the event of discrepancies or incompleteness of the report on relations, the partner whose contributions are not less than 10% of the registered capital (S. 187 (1) Act No. 90/2012 Sb.) or shareholder whose share is no less than 3% of the registered capital that exceeds 100 Mil. CZK with a share no less than 5% of the registered capital that is no less than 100 Mil. CZK may arrange for the court to review this report; in the event that the registered capital of the corporation exceeds 500 Mil. CZK, it is necessary to own no less than 1% of shares (S. 365 Act No. 90/2012 Sb.). Each of these partners may suggest an expert who will be authorized to review the report on relations. However, these suggestions are not binding on the court (S. 86 (1) Act No. 90/2012 Sb.) (Czech Republic, 2012b). Reviews of the report on relations may be carried out only by experts appointed by court (Hejda et al., 2013). The expert refers to a person trained and experienced in performing actions that cannot be performed by an ordinary man without the knowledge that the expert has acquired (Liern et al., 2015). Experts have considerable experience and hold opinions and know facts that must be applied in the assigned task. The task results in the expert's opinion (Bolger, 1994).

Leal (2007) considers the expert's opinion as a reliable source of information for relevant analytic modelling where no relevant data are available. The report on relations must contain these elements: the structure of relations between the controlling and all controlled parties, the role of the controlling party in the group, the manner and means of controlling, the overview of sessions that were summoned by or in the interest of the controlling or other parties (provided this session discussed assets exceeding 10% of the equity of the controlled party; that 10% must be recognized from the last financial statement) that took place within the last accounting period, the overview of contracts between the controlled party, controlling or controlled parties and, last but not least, the opinion on whether the controlled party incurred injury or, alternatively, the opinion on the compensation for the injury under S. 71 and S. 72 Act No. 90/2012 Sb. (Skálová et al., 2017). However, what was said above does not apply if it was proved that the expert could have reasonably and in good faith anticipated that he consciously had acted in behalf of the influenced party (S. 71 (1) Act No. 90/2012 Sb.) (Czech Republic, 2012b).

Wang et al. (2010) analyzed financial statements of a bankrupt corporation and used these statements to identify which circumstances led to its insolvency and whether this insolvency was caused by arising injury. Badriyah et al. (2018) argues that in the event of financial distress of the controlled party, which the party subsequently alleviates by a monetary loan, it is possible for the controlling party to become its guarantor. In such a case the controlling party would have an interest that the controlled party should be able to pay its debts; otherwise, the controlling party itself would be at risk of insolvency (Klieščík et al., 2018). According to Ficbauer and Řezňáková (2014) the improvement of the management of financial resources of the controlling party plays an important role in the relationship between the controlling and controlled party. They also argue that in the event of necessity, the controlling party can be a

creditor to the controlled party. It means that both parties would avoid external financial resources.

The individual levels of the influence of controlling corporations are the influence, controlling and group of companies. The influential party refers to each party that significantly influences the conduct of the business corporation by its decision-making. The influential party is according to S. 74 (1) Act No. 90/2012 Sb. a party that may exercise a direct or indirect crucial influence in the specific business corporation. The highest level is the group of companies. The English literature often terms this level as 'holding' (Fialová, Fiala, 2011). It refers to a group of legal entities with one or more controlling parties (holding corporations) and several controlled parties (Selleng, 2018). Moghaddam et al. (2011) argues that holding corporations are one of the most important structures of legal entities which meet requirements for the stable economic growth. On the other hand, Cho (1998) declares that the ownership structure influences investments within corporations and thereby influences their total value.

Pursuant to S. 79 (3) Act No. 90/2012 Sb. the group of companies shall publish its existence on the internet websites. Together with this, a report on the compensation for potential injury to the controlled party within the group of companies must be published. In the event of injury, BCA allows compensation not only in the form of financial compensation, but also in the form of any other consideration including demonstrable benefits arising from the membership in the group of companies (Korotvička, 2013).

According to S. 75 (2) Act No. 90/2012 Sb. the controlling party must have no less than 40% of all votes in the business corporations (Czech Republic, 2012b). Under S. 75 (4) Act No. 90/2012 Sb. it is stipulated that the controlling party may also become a party that alone or together with parties acting in its behalf disposes of no less than 30% of rights to vote; in addition, this proportion represented more than 50% of rights to vote of the parties present at the sessions of the supreme body in the last 3 consecutive years.

S. 151 – S. 167 of Act No. 89/2012 Sb. stipulates a legal definition of legal entities. It further imposes conditions that legal entities shall observe in order to become a member of legal entity body or to represent another legal entity within this body (Czech Republic, 2012a).

The issue of the review of the report on relations between controlling and controlled parties is the subject-matter of the following case study.

### 3 Materials and methods

The model case describes selected groups of legal entities that entered into specific contracts and whose legal relations in the issue of the controlling and controlled party are regulated under Act No. 90/2012 Sb.; firstly, the model case will demonstrate the identification of the controlling and controlled party from the report on relations drawn up by the controlling party within the specific accounting period.

The analysis of documents will thereby be carried out. The analysis of documents is a set of methodological procedures used for gaining information from documentary sources in the study of social phenomena and processes to explore specific research issues in order to deal with specific research issues. It is a highly practical method of analyzing that was devised for data collection when carrying out a research in which documents can be used as primary or secondary source of information. It is assumed that the documents are or can be considered as reliable evidence of phenomena that occur in the real world. This is closely connected with official documents, yet it can also relate to unofficial ones. Nevertheless, when carrying out a research, all documents that were used in the research should be subject to critical consideration.

What also needs to be observed is the legislation that governs rights and obligations of controlling and controlled parties. It is in particular S. 71 – S. 86 Act No. 90/2012 Sb. and related regulations that need to be complied with. In. No. 89/2012 Sb., it is S. 151- S. 167, where rights and obligations of legal entities and individuals that represent them are stipulated, that will be used as a relevant material for the review (Czech Republic, 2012a).

The key goal of the article is to decide whether injury was inflicted on the controlling party or other members of the group of companies according to S. 71 and S. 72 Act No. 90/2012 Sb., and to decide whether the report on relations complies with formal rules under S. 82 Act No. 90/2012 Sb.

The model case demonstrated a high assumed probability of injury inflicted on the controlled party in the form of inadequate financial performance under contracts made between the controlling and controlled party. All the same, by this conduct, injury can be also inflicted on a party involved, in this case TC (Transport Corporation), which is the minority owner.

The review of prices charged by contracts of lease made between the controlling and controlled party will be carried out by comparative methods after the usual prices have been identified. What will also be carried out is the inspection of payments of these contractual prices according to financial statements of the legal entities concerned. The integral part of the review of contracts that were made will be also other types of contracts that were issued within the group of companies. What will be compared is the adequacy of the required and performed consideration. At the same time, it will be reviewed whether obligations arising from the contracts are duly performed.

Furthermore, we will focus on the analysis of issued and received invoices of the controlled party XYZ. What will be further drawn up is the list of all contracts received or issued by the controlled party XYZ. Based on the Report on relations all issued and received invoices for which a financial consideration was performed will be calculated. The subsequent structure of issued and received invoices will refer to financial relations between the controlling, controlled and other involved parties. In this way it is easier to decide whether injury was inflicted on one of the parties.

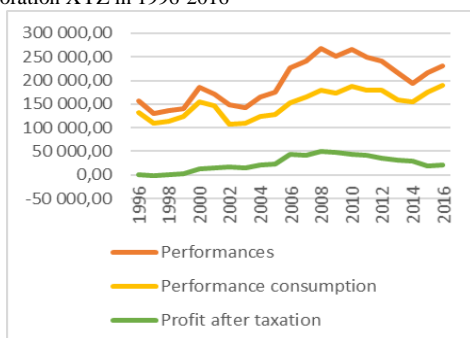
Based on scientific observations a qualitative and quantitative research will be conducted in both areas of the analysis of the Report on relations and the list of issued and received invoices by the controlled party XYZ.

#### 3.1 Structure of relations between parties

In the event of considering legal relations between corporations it is always necessary to correctly identify controlling and controlled parties. According to the available information regarding these legal relations between the controlling and controlled party, corporation ABC is considered to be the controlling one. Corporation ABC holds 70% of shares of controlled corporation XYZ which means that corporation ABC is the majority owner of XYZ and thereby meets the requirements for exercising the right of the controlling party according to S. 75 (2) Act No. 90/2012 Sb. (Czech Republic, 2012b). It is in particular the value of 2,100,000 CZK from the total registered capital of XYZ Corporation, which equals to 3,000,000 CZK. However, the structure of the corporations has yet to be completed. ABC Corporation is controlled by another corporation which is corporation DEF with a residence abroad. Corporation XYZ is a member of international group DEF dealing mainly with outdoor advertising. The next significant shareholder and, at the same time, the minority owner of corporation XYZ is an unnamed transport corporation (hereinafter 'TC') which holds 28% of shares which equals to 840,000 CZK. Pursuant to S. 75 (2) Act No. 90/2012 Sb. TC is not therefore the controlling party. However, there is another minority shareholder (hereinafter 'Z') who owns 2% of shares

from the registered capital of XYZ Corporation (Czech Republic, 2012b). This shareholder thereby fails to meet requirements under S. 365 (2) Act No. 90/2012 Sb. for exerting the decisive influence in the controlled corporation XYZ. Concerning this issue, BCA stipulates that to exert the decisive influence of the shareholder, it is necessary (under S. 365 (2) No. 90/2012 Sb.) to own no less than 5% of the registered capital of the corporation which equals to 60,000 CZK in this particular case (Czech Republic, 2012b). In 201X, shareholder Z was in a very specific position since he was a minority shareholder of corporations XYZ although, at the same time, this person was the Chairman of the Board on behalf of the controlled corporation and, simultaneously, held a position of the corporate agent of corporation ABC on behalf of the controlling party. Throughout the examined period, though, marked fluctuations in the number of shares held by individual shareholders occurred. At a specific moment, shareholder Z owned only 1.3333% of shares (namely 40,000 CZK); however, at the end of the period, he again had 2% of shares. Shareholder Z and corporation ABC saw the fluctuation of 0.667% of shares (namely 40,000 CZK) that occurred between them. When examining the whole network of the corporation including their contracting partners, mutual contracts between seven corporations engaged in different activities are to be dealt with. The remaining corporations will be marked as X1 – X4. Nevertheless, activities of all these corporations can be combined. The provision of advertising areas by XYZ Corporation for remuneration from DEF Advertising Corporation may be given as an example.

Fig. 1. The development of selected economic ratios of corporation XYZ in 1996-2016

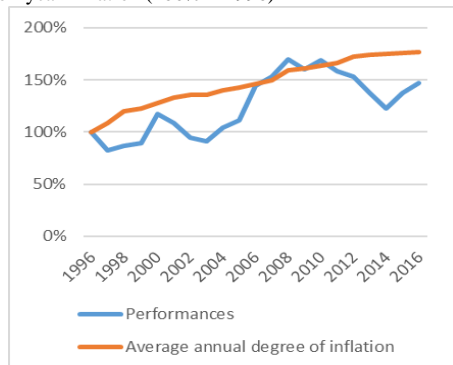


Source: www.justice.cz; Public register and the Collection of documents.

The development in Fig. 1 demonstrates the fluctuation in both – performances and performance consumption of corporation XYZ. The profit began to plunge after taxation after the economic crisis in 2008.

For a more careful consideration of the development of the situation of corporation XYZ, we can compare its performances with an average annual degree of inflation which is depicted in Fig. 2.

Fig 2. The comparison of performances of corporation XYZ and year-on-year inflation (100% = 1996)

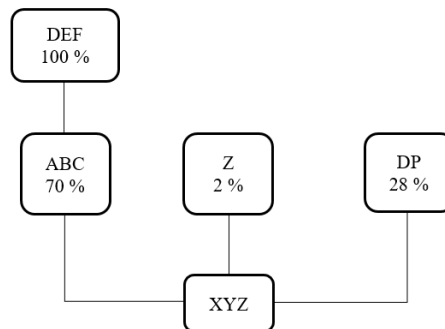


Source: www.justice.cz; Public register and the Collection of documents, Czech Statistical Office.

In case a corporation flourishes, its performances should annually increase by no less than the degree of inflation in the specific year. The corporation responds to the inflation increase by pushing up prices of its products and services (Irima, Stancu, 2013). Fig. 2 shows that performances of the corporation began to plunge since 2010 and began to increase no less than 4 years later.

Fig. 3 illustrates individual relations between the controlling and controlled party and other minority owners.

Fig. 3. Relations between the members of the group of companies



Source: Author's own graphic interpretation.

#### 4 Results

Having conducted the research, there was a certain deficiency in the Report on relations for this particular model case. It is an inaccurate identification of legal entities as (parties) controlling and controlled. This is directly contrary to Act No. 90/2012 Sb. The controlled corporation XYZ is controlled on the basis of majority ownership of its shares by the ABC Corporation. According to another research, it may be stated that s. 82 (2) (b - d) Act No. 90/2012 Sb. has always been formally and correctly fulfilled by XYZ. Only a different degree of accuracy may be noted. In the period under review, there were minor fluctuations in the number of held shares of the controlled corporation XYZ between the controlling ABC Corporation and the minority shareholder Z. Content deficiencies of the Report on relations to be reproached involve a list of contracts. The list of contracts does not include all contracts made between the controlling party and the controlled party. For this reason, it is necessary to remark that s. 82 (2) (e) of Act No. 90/2012 Sb. was not properly fulfilled.

Yet, according to the information available, it may be claimed that s. 82 (2) (a) Act No. 90/2012 Sb. was not sufficiently fulfilled either, but it was not such a serious error that would cause any injury to the controlled party or other member of the group of companies. Act No. 90/2012 Sb. does not clearly regulate the way in which the structure of controlling and controlled parties is to be expressed in reports on relations. In this case, however, the Report on relations contained a combination of graphical and textual representation, with the former being depicted as the first. Not all shareholders were included in the graphical representation though as they were only listed in the textual section below the graphical representation. Judging from experience, it may be argued that on viewing the graphical representation, shareholders can easily be omitted in the textual part.

Further formal shortcoming was found while examining the list of all contracts included in the Report on relations. It encompassed two contracts that were classified as oral by the controlling company and were not listed in the contracts. Specifically, it was the rental of advertising space and of office space. However, receivables from them were normally invoiced to the controlled company. It was also found that several contracts made in writing were not included in the Report on relations. Apart from that, the existence of the contracts is supported by accounting transactions of performance whose

claim arose from the contracts' subject-matter. The controlled corporation XYZ had an agreement with the controlling company ABC on the provision of advertising and other cooperation in the field of advertising. Then, there were five other contracts signed with the foreign group DEF. They comprised a contract for work, a contract for ordering advertising space, a contract for sublease and provision of services, a contract for providing accounting services, and a contract for the use of hardware and software.

The minority owner (TC) of XYZ believed that the performance, based on issued invoices for the services of the controlling party ABC, was disproportionately high, hence resulting in an intentional decrease in profit of controlled party XYZ in order to reduce dividends to be paid by TC as the minority owner of the corporation XYZ. According to the authors' findings in this area, there was no invoicing of higher valuable consideration for the services provided by the controlling party to the controlled party. The consideration charged for invoiced services was reasonable in the period under review and was in line with the current market situation.

At the instigation of TC as the minority owner of the company XYZ, a possibility that TC was not harmed by the controlling party's conduct would also be reviewed.

In the matter of harm according to s. 71 and s. 72 of Act No. 90/2012 Sb. (being the subject to s. 82 (2) (f) Act No. 90/2012 Sb.), the controlled party (XYZ) was paid all issued and received invoices based on cash flows between individual companies. However, uneven invoicing intervals were identified here. This undoubtedly violated contractual terms between the parties. Some contracts were violated in the manner that that the intervals were random, whereas other contracts were being violated from their start. For instance, the accounting service contract, where quarterly invoicing had been negotiated, was actually invoiced on a monthly basis. However, there was no harm to TC as a result of higher invoicing frequency and reimbursement.

Moreover, particular inaccuracies in the invoicing process between ABC and XYZ were identified as well. They result from a specific part of the contract dealing with a manner of invoicing. Non-compliance with the invoicing procedure did not cause any injury to the controlled corporation XYZ, since it was only to simplify the entire invoicing system between the above-mentioned parties. In relation to the finding, it may be stated that no injury was inflicted on XYZ or TC in this respect.

An interesting finding is also the structure of invoices issued by XYZ to other members of the business group. While researching, XYZ was found to be a 100% owner of the corporation X2 which is a 50% owner of the corporation X3. The controlling corporation ABC is a 100% owner of the corporation X1. And the foreign corporation DEF is a 100% owner of X4.

Table 1 shows a particular volume of invoices issued by XYZ to ABC and X1 – X4 in 201X excluding VAT.

Tab. 1. Invoices issued by XYZ in 201X (excluding VAT)

Company	Amount [CZK]
ABC	169,427,982.8
X1	129,560.0
X2	7,347,479.6
X3	308,907.0
X4	11,351,544.9
Total	188,565,474.3

Source: Documents provided by XYZ.

As may be gathered from Table 1, XYZ invoiced most of the receivables of controlling corporation ABC. Overall, it represents 89.6% of the total invoiced receivables.

A different standpoint is provided in Table 2 which lists invoiced receivables of X1, ABC and DEF towards XYZ without VAT.

Tab. 2. Invoices received by XYZ (excluding VAT)

Company	Amount [CZK]
X1	3,077,642.0
ABC	750,063.6
DEF	13,504,690.5
Total	17,332,396.1

Source: Documents provided by XYZ.

Table 2 clearly shows that the foreign company DEF had the largest receivables in relation to the controlled company XYZ in 201X. This was 77.9% of the total invoiced liabilities.

In total, XYZ issued invoices for labor costs, rental of advertising equipment, rental of advertising space, costs of the selected period and other rental. From its business partners, XYZ received invoices for construction, IT services, marketing, labor costs from X1 and X4, landline and other charges, and costs over invoice.

## 5 Conclusion

The Report on relations, drawn up by ABC as the controlling party, was researched in the area of formal requirements placed on it and assessed regarding possible occurrence of injury to the controlled party XYZ and TC as the minority owner by the controlling party ABC for a certain period. Considering the violation of s. 71 and s. 72 Act No. 90/2012 Sb., no faults were found in the controlling party's conduct. The same conclusion was also reached with regard to s. 82 (2) (a – d) Act No. 90/2012 Sb. In relation to s. 82 (2) (e) Act No. 90/2012 Sb., incompleteness was found in the list of all contracts made between the controlling party and the controlled party.

There are also several inaccuracies, or minor faults, regarding compliance with contracts on providing individual services. However, these minor inaccuracies did not cause any injury to the controlled party XYZ or its minority owner. The main issue was the amount of negotiated and subsequently invoiced prices for services provided and the lease to the controlled party by the controlling party.

Thus, the agreed performance was verified. Owing to the nature of the contract's subject, the verification was performed by comparing usual rents in the given location. The authors determined a rent of non-residential premises and concluded that the claimed performance broadly corresponds to the usual rent. Also, the agreed monetary rewards for each service provided were always commensurate with the regular prices for this type of services in the reporting period.

Also, the adequacy of contractual performance on other concluded contracts was examined. However, a specific nature of the contract's subject must always be taken into account. The authors succeeded in verifying performance of the contracts for advertising and other cooperation in advertising, the contract for work, for ordering advertising space, accounting service contracts and contracts for the use of hardware and software, concluding that in all of the above contracts the consideration agreed was proportionate to the nature of the contracts' subject and the current state of the market.

As regards the formal correctness of the Report on relations, it should be noted that the Report did not give a clear indication of the actual relationship between individual parties, and it was not clear enough as to who in the group was in the position of controlling party and controlled party. Given the complexity of the whole structure, more attention should have been drawn to this section.

In conclusion, it may be reported that the controlling parties did not cause any injury to the controlled party or the minority owner. This statement is based on all the findings made throughout the research while finding answers to all the above questions. Considering the scope of information available from

the Report on relations, the paper's objective was therefore satisfactorily met and its contribution is clear.

Other companies with similar legal relations should in the future ensure compliance with the aforementioned legal requirements. However, it should be noted that not only a breach of this legislation may cause injury to the controlled party by the controlling party. In addition, certain injury may be caused either intentionally or unintentionally to other owners.

Both contracting parties should pay meticulous attention particularly to contracts in the area of legal and advisory services, where verification of their adequacy is considerably complicated, as is verification of the actual provision of the contract's subject-matter, as well as their timely payment and entry in the accounts. It is also necessary to point out that an irregularity in invoicing between the parties may cause injury to one of the members of the group of companies. Yet, this did not occur in the model case presented as invoices were issued and paid at shorter intervals than previously agreed. Thus, there was no injury related to the minority owner. Assiduous attention should also be paid by all companies to unusual invoices for items not regularly invoiced to them in order to avoid any errors in financial statements or cash flow. Examples of such invoices may include bump advertising or necessary needs of corporations depending on surrounding influences.

Reviewing the Report on relations should consist of two parts, one of which is verification of formalities required by the legislation, the other being occurrence of the actual injury itself. In the above case, the occurrence of injury, theoretically resulting from the inadequate performance provided, was addressed. If the inadequate performance was provided without proper justification, it could be demonstrably classified as deliberate injury to the controlled corporation and the minority owner.

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**Secondary Paper Section: AE, AH**