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# Business management in the Czech Republic

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# INTRODUCTION

This course covers a wide range of topics and due to the high number of lecturers (more than one topic for a lecturer) it familiarizes students mainly with the focus of the Department of Corporate Economy. The course is designed especially for foreign students and it provides them, among others, with an overview of issues dealt with by contemporary Czech corporate economy. Students will further explore some present-day problems in the Czech Republic, their causes and solutions.

Students will be introduced to the transformation of the corporate sector after 1989 and its development (focusing on industry) up to the present day. The topics further include foreign investments and their importance for the Czech Republic and Czech companies, the legal framework for business activities, and the conditions to be fulfilled in order to set up one's own business in the Czech Republic. Students will also examine the economic impact of the accession of the Czech Republic into the EU, the financial analysis for evaluation of the impacts, and accounting standards used in Czech businesses. Moreover, the course makes students familiar with forms of strategic partnerships and their importance particularly for small and medium enterprises, Czech consumer protection and the Czech National Quality Program. The course also provides an insight into development and structure of retail in the Czech Republic, advertising and promotion, and the recent phenomenon of m-commerce.

From the above-mentioned list of topics it is obvious that the course covers a relatively wide spectrum of issues. Its aim is not to go into great details about the extensive and complex structure of Czech corporate sector, rather, it intends to outline the individual topics and attract students further to a deeper study of selected topics in other courses. Therefore we hope that the course Business Management in the Czech Republic, represented by this textbook, will provide a welcome stimulation for students in their studies.

*Authors*

# 1 ECONOMIC TRANSITION OF CORPORATE SECTOR: FROM CENTRAL PLANNED TO MARKET ECONOMY

## 1.1 The Methods of privatisation

The question regarding the various methods of privatisation has attracted widespread discussion in the economic literature concerning the transition process of the former socialist countries to market-style economic systems. There exists a wide range of proposals on how to privatise state companies and assets.

These proposals and forms can basically be divided into **direct and indirect methods of privatisation of state-owned enterprises**.

**The direct methods** include forms such as public auctions, tenders, public invitations, capital privatisation and employee or management buy-outs.

**Indirect methods** include different distribution schemes elaborated to privatise a large bundle of state-owned enterprises in a mass privatisation programme. Much more interesting, however, is an analysis of the restructuring and efficiency-enhancing progress following the ownership change.

### 1.1.1 Theoretical elements of privatisation

Privatisation should result in a new private and institutional ownership structure replacing the old sclerotic state-administered system with its low efficiency pressure and distorted market and price signals. There is little doubt that private ownership leads to an incentive system in which the costs of production are minimised according to the relative price structure and the output structure is oriented toward market signals given by the preference structure.

Privatisation-in connection with deregulation and demonopolisation-is expected to reform and overcome the inherited industrial structure characterised by, to some extent extreme, **horizontal and vertical concentration**. The new definition of the principal-agent relation serves as a reformed framework for cost-effective and profit-oriented market behaviour.

In the framework of a general hardening of budget constraints, privatisation of state-owned enterprises is conceived to be fundamental, accompanied by the enabling of market entry and the consequent enforcement of market exit. Nevertheless it has been emphasised that necessary financial, organisational and technological restructuring has to take place in the state-owned industrial sector before privatisation. Hence privatisation attempts to overcome the 'no-entry, no-exit economy', which is characterised by soft credit constraints, laxity in tax collection, direct subsidies for industrial policy motives, protectionism and selective sectoral policies.

Widespread privatisation, necessarily including the banking sector, is thought to remove the inefficient capital and labour allocation that are well known defects of socialist economic systems. Capital wasting and labour hoarding as effects of distorted relative prices and market structures can only be eliminated in the framework of a microeconomically sound ownership structure.

A socioeconomic argument in favour of privatisation is strongly related to Hayek's conception of a pluralistic society of owners as the basis of a modern market economy and even of democracy. This has nothing to do with widespread and diffuse 'people's capitalism', in which

hardly anyone would be able to exert control rights, but more with the creation of a middle class and solid market-oriented management and entrepreneurship in companies.

### **1.1.2 Speed of privatisation and restructuring**

In these discussions the term 'gradualism' has often been the subject of serious misinterpretation, as many authors favoured, more or less, a big-bang approach with rapid and simultaneous introduction of shock elements. A more gradual approach, however, is not considered to mean the maintenance of old, ossified structures or the prevention of necessary economic adjustments, but rather the search for an 'optimal' path of transformation, in which unnecessarily high social costs of transition are avoided.

The **negative attitude** towards the term 'gradualism' stems from the disastrous results of gradual macroeconomic programmes in developing countries. There are nevertheless key differences between the economic transformation of Central and Eastern Europe and the stabilisation and adjustment in middle-income or developing countries.

Theoretical contributions to the issue of the pace of the transformation and especially of the privatisation and restructuring processes attempt to deal with the various trade-offs between efficiency gains through radical adjustment and social costs of transformation. The decision between radical and gradual reforms has to be regarded as a consideration of the impact of full or partial reforms. It can be argued that a full reform provides faster and higher allocative efficiency gains, but also higher 'transformation costs'. Transformation costs emerge as a consequence of structural adjustments to a real relative price system and consist of financial compensation to different kinds of 'losers' in the process (i.e. as a result of higher unemployment). Financial compensation has to be borne by the public financial system and is a threat to fiscal stabilisation especially in times of declining state revenue owing to an output collapse.

Partial reforms, however, would lead to moderate efficiency gains and lower transformation costs because financial compensation through the state budget would be lower. The choice of the more gradual approach is then justified if the difference between high efficiency gains (radical) and moderate efficiency gains (gradual) is smaller than the difference between higher financial compensation (radical) and lower financial compensation (gradual). Moreover, the fact that the financial room for manoeuvre through revenue policy (especially tax collection) is, at least in the beginning, rather limited must be taken into consideration.

To summarise, the achievement of an irreversibly privatised capital stock is an important condition for the stability of the process, whereas the level of transformation costs and its implications limit the possibilities of implementing the big-bang approach. Credibility and coherence of the reform packages play a decisive role in overcoming ossified property structures through a well-elaborated privatisation strategy.

### **1.1.3 Ownership change and restructuring progress**

The restructuring process is conceived as a microeconomic adjustment process with organisational, financial and technological restructuring steps. It will be seen that mere ownership change is insufficient to ensure that the intended restructuring measures are taken. What is decisive for the reallocation of factors are learning processes initiated through raised efficiency pressure, a reformed incentive structure which leads to wide-ranging restructuring efforts and adjustments to changing relative price information. The identification of dynamic processes of factor reallocation plays an important role in this context, just as does the transfer of foreign capital and know-how to upgraded production structures. In addition to the



importance of foreign capital, management concepts and new technologies, the role of banks in initiating adjustment measures deserves a thorough examination.

Restructuring efforts rely not only on ownership structure and its changes but to a large extent on the elimination of deficits in establishing a sound competitive environment and an institutional setting which accomplishes the actual ownership transfer.

Competitive markets are a necessary precondition for exerting pressure on restructuring in privatised companies. Imperfections on product and factor markets lead to maintenance of inherited dysfunctions in relative prices and lack of cost awareness and demand orientation. Despite widespread liberalisation and deregulation, market structures are characterised by a lack of pressure through competition and the enforcement of market exit. Hence, hardened budget constraints cannot bite efficiently into concentrated markets.

The creation of flexible labour markets has to face various rigidities which contributed to a drastic increase in long-term unemployment. Institutional imperfections exist owing to labour regulations and increasing resistance on the part of the losers in the transition process, who were laid off because of massive over-employment and labour hoarding. The absence of appropriate wage differentials, flexibility of the real wage and labour mobility impede the restructuring efforts, since the surplus factor labour cannot be allocated in an efficient way.

Weak financial and capital markets, due to infrastructural shortcomings and systematic financial underdevelopment in socialist systems, indicate that urgently necessary capital resources for the implementation of restructuring measures are not being provided. The scarcity of capital is aggravated by the fact that the demand for credits cannot be met because of an underdeveloped banking system. A restrictive and stability-oriented monetary policy and high real interest rates, which arise because of high interest spreads in the banking system, hamper access to credit especially for small and medium-sized enterprises. Moreover, fiscal deficits lead to the well-known 'crowding out' effect, which reduces the share of enterprises in the overall credit volume in an economy.

#### **1.1.4 Restructuring and the role of the state**

Even if the privatisation and ownership reform in the Visegrad countries has been progressing steadily in the past years of transformation to a market economy system, the influence of the state and its agencies remains strong and persistently interventionist. Equity holdings and industrial policy motives dominate especially in those sensitive and problematic sectors in which state influence is supposed to be retained because of dubious public good justifications. Although privatisation in industry already achieved a level in 1995 which can be compared with fully fledged market economies and definitely goes beyond a threshold level which makes the reform process irreversible, many other areas are still exempted from the ownership reform.

The high figures for the industrial sector in the Czech Republic are the result of the application of non-standard methods of distribution through coupons. In fact, a less clear picture of the separation between state ownership and private forms of property appears because of institutional connections with investment companies and funds in which the state is either directly or indirectly present or exerts influence through state-owned banks. In both countries the state and its agencies still have a strong sway in aspects of industrial and structural policies, especially in sectors in distress. Hence it is no surprise that the importance of the market exit mechanism and competitive rules in problematic and sensitive areas is undermined by politically oriented motives which do not reduce state interventions.

The conclusion is that the ownership change exerts a significant influence on the adjustment process and performance of enterprises. The difference between privatised and remaining state-owned firms is evident in all countries considered. That can be attributed to the overall hardened budget constraints in which tough market exit enforcement and significantly hardened credit constraints play a major role.

Although the privatisation progress has initiated a radical new definition of the state's role and activities in an economy, a number of dysfunctions and dilemmas can be identified because of continued state interventionism.

In addition to the existing state ownership shares in enterprises held in public holdings and the resulting direct influence on the allocation of factors and resources, the danger arises that interventionism will be perpetuated for industrial policy reasons. 'Conservation' of horizontal and vertical channels of negotiation and ossified organisational structures adversely affect the modernisation of old production technologies and structural change through far-reaching restructuring efforts.

In the course of the coupon privatisation, which started with the aim of reducing state influence drastically, indirect intervention through direct share holding or via financial institutions partially owned by state authorities is still prevalent. Sectors of strategic importance are especially the target of political interventions to secure the state's 'grip' on economic development. The defence industry, engineering, banking and insurance companies belong to the category of sectors of strategic interest. Despite the formal dissolution of the Czech Ministry of Privatisation, the role of the National Wealth Fund as a direct or indirect owner of shares in partially privatised companies remains strong.

The government's intention is often to maintain state influence and property forms because of the government's multiple target function. State property is hence characterised by the dominance of insiders and the exclusion of competition. The exertion of state control and corporate governance activities-partially also in respect of operational management-encounters similar restrictions to those in the former socialist system. Administrative shortcomings, the mutual overlapping of industrial and social policy objectives and particularly the vertical structure of negotiations for scarce factors and resources undermine efficiency orientation and cost awareness. A state portfolio consisting of company shares and government resistance to giving up its sphere of intervention in selected production areas lead to perverse incentives for restructuring and adjustment. Private (foreign) investors are then excluded from take-overs and share participation. The consequence of an absence of commitment to a market-based privatisation conception is that external sources of investment in the form of venture capital are retarded and the solution of the conflict between the principal and agents, elimination of which is an essential goal of the microeconomic adjustment process, is far from being resolved.

## 1.2 Transformation in the Czech Republic

In 1989 the private sector produced a small share of GDP in these three countries: less than 5% in Czechoslovakia, approximately 15% in Hungary and about 20% in Poland. Thus the potential scope for privatisation-through divestiture of state activities as well as from private start-ups-was enormous.

It is important to distinguish **three concepts** of transformation of a state-owned enterprise (SOE).

**Corporatisation** creates a new separate legal entity for the firm by converting an SOE into a joint-stock company (JSC) all of whose shares are (initially) held by the State Treasury.

**Commercialisation** implies that the new JSC, unlike the former SOE, will be run as a profit-seeking business.

**Privatisation** entails divestiture of (some of) the JSC's shares by one or a combination of various methods, such as initial public offerings, public tenders, management and employee buy-outs, and auctions of shares for vouchers distributed free under a mass privatisation scheme.

Corporatisation by itself clarifies property rights, now to be exercised by the government agency representing the state as shareholder in the JSC. Corporatisation may regain for the state as shareholder some property rights previously ceded to, or usurped by, enterprise managers or workers. Also, by expressing ownership in numerous separate JSC shares, corporatisation facilitates privatisation-by disposal of blocks of shares-when an enterprise is too large to be sold in its entirety to a single buyer.

In the Czech Republic commercialisation without privatisation was supported by some SOE managers and some government officials who wanted a very slow and thus selective privatisation process. However, the government adopted a broad privatisation programme that divested a large amount of state property within a few years.

Because the Ministry of privatisation (MOP) and the National property fund (NPF) did not have sufficient qualified staff for a broad and rapid privatisation programme, they delegated some of the negotiations with buyers of state property to enterprises. Also, the privatisation agencies hired foreign consulting firms for a wide range of assignments, including advice on basic privatisation strategy, review of specific privatisation projects, identification of potential foreign investors, and negotiations with them. However, the foreign consultants often lacked appropriate experience for their tasks, as well as familiarity with local conditions and the Czech language. There was a large turnover in foreign advisers, with a long and costly learning process. Foreign consultants' fees were considered high for the services furnished.

The Czech privatisation process was weak in many aspects of transparency. The MOP did not reveal the multiple criteria (and their relative weights) for its choice among competing privatisation projects. The NPF lacked standard procedures for public tenders and firm deadlines for decisions about them. Also, the NPF did not always enforce buyers' obligations to pay as scheduled for assets obtained in tenders or direct sales.

Czech privatisation was characterised by extensive corruption. There was excessive administrative discretion, because the legislative framework was too broad, stating only general principles and leaving key features to executive branch decrees and ad hoc bureaucratic decisions. The system of laws and rules was vague and weak. A striking instance of misappropriation occurred in 1991 when a government official bought a wholesale book distributor with prime real estate in central Prague for a nominal price. Though not accused of personal impropriety, the head of the NPF resigned in 1994 after disclosure of irregularities in the privatisation of specific companies, such as the sale of shares to a buyer not included in the approved privatisation project. The director of the Centre for Voucher Privatisation was arrested in 1994 for taking a cash bribe to arrange the sale of shares in a dairy company.

**Mass privatization** refers to the transferring en masse of the ownership of SOEs to various combinations of workers, citizens, and other types of investors. Stated differently, privatization is a means to meet societal needs through greater reliance on private institutions while de-emphasizing the government's role. It is a means to attain economic benefits equivalent to creating long-term investor wealth. **Five conditions** have to be fulfilled, to attain privatization:

1. On a micro-scale, the enterprise has to be sold off and management control and ownership have to be firmly rooted in the private sector.
2. Privatization works best if it is carried out in a competitive environment so that the SOE has to cope with liberalized markets-in which barriers to entry are minimized-for its products.
3. State subsidies and policy loans should be eliminated.
4. The SOE monopoly prices have to be regulated with a pricing formula that keeps pressure on management to improve efficiency.
5. The markets that surround the SOEs on the output and input sides must be liberalized at the same time.

Furthermore, the motivation that drives the government-owned companies to privatize may provide evidence as to whether these conditions for success will be met. In the case of the Czech Republic, as well as other former communist countries, privatization became the vehicle used to return the property that was taken from the people back to the people. Thus, the privatization process was accelerated in an effort to gain public support.

Privatization of the Czech SOE's came under the leadership of former Prime Minister Vaclav Klaus. Privatization took place in two waves of auctions and involved approximately 3,000 targeted firms. Completed in 1992, the first wave involved 1,490 companies with 93% of the offered shares taken up by investors. By the beginning of 1995, the second wave was completed, and approximately 80% of the economy had been privatized.

There are **many possible methods** to attain privatization, including **government contracts with private firms, government franchises with private organizations, entrepreneurial ventures, and vouchers**. Czech government officials selected **two basic methods** of privatizing the SOEs:

1. corporatization and the subsequent sale of formerly SOEs to private bodies
2. voucher privatization, a nontraditional privatization technique based on free distribution of the SOEs' shares to the general population.

Under the latter approach, every adult citizen ages 18 and older was given the opportunity to buy investment vouchers-i 1,000 points of investment money with limited maturity-for a registration fee of Kcs 1,000 (U.S. \$34), representing approximately 25% of the average monthly wage. These vouchers, in turn, entitled Czech citizens to bid for ownership shares of any company privatized by the voucher method or to allocate their shares to an investment fund that would make investment decisions for them.

Although this approach eliminated any privatization sales proceeds that the government might have otherwise collected, it allowed for a quick transition to investor ownership and corporate restructuring. Furthermore, it guaranteed that a maximum number of Czech citizens could participate in the process despite their obvious lack of capital. The voucher system thus created a property-owning middle class that, in turn, was expected to increase the efficiency of corporate management and raise the productivity of the resulting economy.

The Czech voucher program was considered a unique approach because it was carried out from the bottom up. All state enterprises considered eligible for privatization were required to reorganize as corporations and select one of the methods of privatization. The process unleashed a sense of freedom in managers to reshape their companies. At the same time, it provided a positive momentum that steered the countrywide reformation.

Early critics of the voucher process suggested that only those firms not attractive to potential buyers (i.e., the weakest firms) would be privatized through vouchers. However, a study by the Czech Statistical Bureau found the opposite. On average, profitability of those enterprises involved in the voucher scheme was considerably higher than the average reported profitability of any and all Czech firms. Specifically, voucher firms comprise 31.6% of all profit-making firms but only 13.4% of loss-making firms. Contrary to expectations, individuals with majority holdings in investment privatization funds became intimately involved in the corporate decision-making of the enterprises. As a result, more structural changes were seen in these firms, including alterations of products and production.

Although voucher privatization was publicly applauded, did it result in economic benefit for the stakeholders of these newly liberated firms? After 40 years of communism, the financial markets and local participants were relatively inexperienced. The deregulation of the banking industry was fraught with problems, such that the majority is still government controlled. Similar problems erupted with the stock market, established shortly after the fall of the Communist government. These problems, coupled with the fact that the voucher process impeded the ability to have a concentrated ownership share, made it quite difficult to force significant management/employee change. Consequently, many of the early privatized firms have exited the market. Many others have aligned with foreign partners.

Mass privatization of state owned companies is a challenge given that domestic financial markets are under-developed or non-existent. Not only is there little private capital for investment in these companies, but the lack of financial markets also means the lack of useful asset pricing signals. Further, there is generally a lack of appropriately trained analysts and other professionals necessary for valuing companies being privatized. The auction process used in the Czech voucher-based mass privatization process was designed to overcome these limitations. It was unique when it was implemented and it was widely considered to be a success in distributing Czech state owned companies.

### 1.3 Appendix 1 - Situation in the Industry of the Czech Republic after 1997

In 1997 there was a crisis in monetary area in the Czech Republic, that caused a decrease of Czech economy. The Czech government provisions led to a diversion of this monetary crisis (with the help of a monetary restriction), but on the other hand caused the economic fall and it influenced most of the enterprises in the Czech Republic negatively. The year 1997 was a turning point, which started a new stage of development of enterprises in the Czech Republic. What was the situation in the enterprises of industry after the year 1997?

#### 1.3.1 Output, employment and productivity in year 1998

**Industrial production** increased by 1.6% and receipts (in constant prices) by 0.6% (in 1997 by 4.5% and 6.1% respectively). After fast advance of the growth rate in the 1st quarter the rate of expansion slackened in the 2nd and particularly the 3rd quarter, to plunge into decline in the 4th quarter in connection with depression of external and internal demand and with the deterioration of the financial situation of enterprises.

In the course of 1998 the financial situation of large enterprises substantially worsened. Though the order books among many of them showed satisfactory demand for their products,

they had no possibility of receiving credits and to finance their production. In this respect the Ministry of Industry and Trade is taking measures to improve the situation.

**Employment** in industrial organisations with 20 and more employees **declined** by 3.0% (of individual branches most considerably in manufacture of coke and refined petroleum products, by 12.5%, and in manufacture of leather and leather products, by 10.2%). Growth of employment was registered only in manufacture of rubber and plastic products (by 3%) and in manufacture of electrical and optical equipment (by 2.9%). **The average nominal wage** increased by 10.5%, but with real wages dropping by 0.2% (in 1997 the corresponding figures were the growth of 13.5% and 4.6%).

**Labour productivity** (from the index of industrial production) in organisations with 20 and more employees increased by 4.7% (in manufacturing by 5.2%, in mining by 2.2% and in energy sections by 3%). **The real wage** (deflated by the index of industrial producers) grew by 5.3%.

### 1.3.2 Output, employment and productivity in year 1999

**Industrial production** declined on a year-on-year basis by 3.1%, **receipts from industrial activity** in constant prices by 0.5% (production in 1998 increased 1.6% and receipts 0.6%). After a marked decline in the 1st quarter and its gradual deceleration in the 2nd and 3rd quarters, production resumed its growth again in the 4th quarter, in connection with expanding exports. As compared with the 1990 yearly average, industrial production was 14.3% lower.

Table No. 1: Production, sales and employment in 1999

Indicator		Unit	1997	1998	1999	2000
Industrial production index		%	104.5	101.6	96.9	105.1
Sales from industrial activities	curr. p.	bln CZK	1507.7	1620.7	1645.3	1849.0
		%	110.6	105.2	100.6	112.6
(constant prices – 1994 yearly average)	const. p.	bln CZK	1295.1	1324.3	1332.2	1432.2
		%	106.1	100.6	99.5	107.7
Monthly average 1990 = 100	const. p.	%	85.7	86.2	85.7	-
Share of non-state sphere (end of period)		%	78.3	84.1	-	-
Average number of employees		th. pers.	1295	1290	1217	1165
		%	95.7	97.0	94.8	97.3
Labour productivity <sup>*)</sup>		%	109.2	104.7	102.2	108.0
Average sales per employee	const. p.	tis. CZK	83.3	85.5	91.3	102.5
		%	110.9	103.7	104.9	110.7
Average monthly wage		CZK	10780	11876	12656	13566
		%	113.5	110.5	106.6	106.2

Source: www.czso.cz

**Employment was curbed** by 5.2% (in the individual quarters the rate of decline accelerated). In the framework of manufacturing the largest reduction was recorded in the chemical and pharmaceutical industry (by 11.3%) and the leather industry (by 10.5%). Employment failed to increase in any branch; it grew, however, in the sector under foreign control.

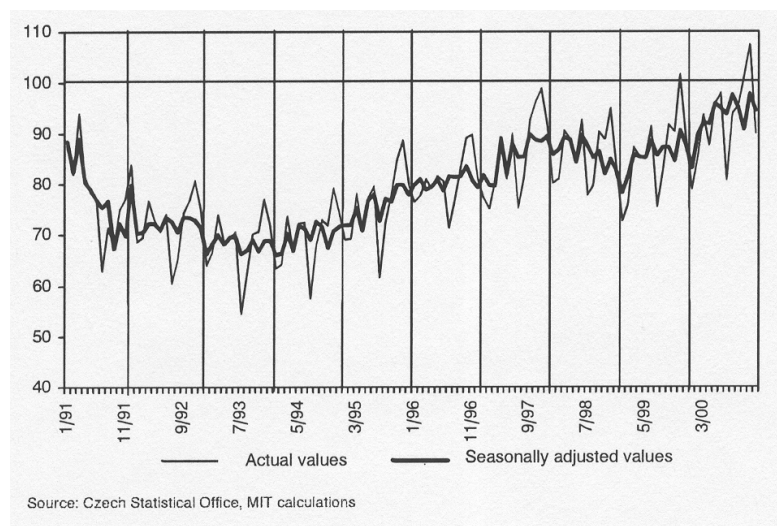
**The average nominal wage** increased by 6.6%, **real wages** by 5.5% (deflated by the price index of industrial producers) and by 4.4% (deflated by the index of consumer prices). **Labour productivity** from the index of industrial production picked up by 2.2% (in manufacturing by 2.2%, in the energy sector by 1.7%, but in mining it shrank by 0.6%). **Advance of the growth rate of labour productivity over the rate of growth of real wages** was not achieved in any of the three industrial aggregates and in only six branches (out of the total number of 14 branches) within manufacturing.

### 1.3.3 Output, employment and productivity in year 2000

Industrial production in year 2000 reached the highest growth since the transformation of the economy and almost approached the 1990 whole year average (see graph No. 1). There were only 7.6% missing and the interannual improvement was 6.7 points. From the point of view of the individual months, the 1990 level was exceeded for the first time in 1999 by 1.6%, and then in October 2000 by 1.3%, significantly again in November by 7.4% (according to the MIT calculations). When compared with the 1995 whole year average, the total industrial production was higher by 12.4%. Industrial production increased in 2000 interannually by 5.1%, the receipts (in constant prices) increased by 7.7% (the production declined interannually in the previous year by 3.1% and the receipts decreased by 0.5%).

Graph No. 1 Long-term development in the industrial production

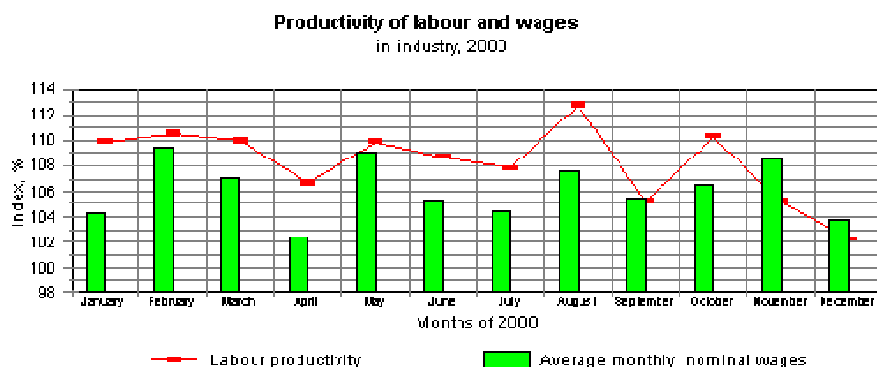
(Indices in constant prices, 1990 monthly average = 100)



Source: [www.czso.cz](http://www.czso.cz)

The **number of employees** in December 2000 dropped by 0.8%, compared with December 1999. Total employment in industry in January to December 2000 fell by 2.7% year-on-year, the decrease decelerating gradually during the year. The **average monthly nominal wages** (including those accounted but not paid) went up by 3.7% y-o-y in December 2000 and reached CZK 14 689 per employee. The **average monthly real wages** (calculated using the consumer price index) decreased by 0.3% in December 2000 y-o-y, while the **productivity of labour** grew by 2.2%. The average nominal wages in January to December 2000 were up by 6.2% y-o-y and amounted to CZK 13 566 per employee. Real wages in the same period were higher by 2.2% and the productivity of labour rose by 8.0%. The rise in the productivity of labour was higher than the growth in the average nominal wages.

Graph No. 2: Productivity of labour and wages



Source: www.czso.cz

### 1.3.4 Output, employment and productivity in year 2001

Compared with the average month of the base year 1995, industrial production in November 2001 was by 30.6% higher. Industrial production in November 2001 grew by 6.6% year-on-year. Against October 2001, industrial production in November 2001 rose by 3.8%. Compared with the some period of 2000, industrial production in January to November 2001 was by 6.8% higher. **Sales in industry** reached in November 2001 by enterprises (legal and natural persons employing 20 people or more) grew by 4.0% year-on-year at constant prices (2000 average prices).

**The number of employees** in November 2001 in the whole industry fell by about 13.4 thousand persons i.e. 1.1%, compared to November 2000. The decrease was recorded in the mainly industrial branches, except for manufacture of wood and wood products, manufacture of rubber and plastic products, manufacture of basic metals and fabricated metal products and manufacture of transport equipment. **The average monthly nominal wage** (incl. those accounted but not paid) amounted to CZK 16 906 per employee in November 2001 and grew by 4.3%. The highest average monthly nominal wages were reported in ‘electricity, gas and water supply’, the lowest were in manufacturing (in manufacture of leather and leather products amounted to CZK 9 811). **Labour productivity** in November 2001 grew 5.2%. The highest figures were observed in ‘electricity, gas and water supply’ (109.4%), in ‘mining and quarrying’ reached 104.8% and in ‘manufacturing’ 104.1%. Unit wage costs were 0.9 percentage point lower y-o-y.

### 1.3.5 Output, employment and productivity in year 2002

Compared with the average month of the base year 2000, **industrial production** in December 2002 was by 8.3% higher. Industrial production in December 2002 grew by 6.6% year-on-year. Compared with the some period of 2001, industrial production in January to December 2002 was by 4.8% higher.

**Sales in industry** reached in December 2002 by enterprises (legal and natural persons employing 20 people or more) increased 5.3% year-on-year at constant prices. The growth of industrial sales occurred in mining and quarrying and manufacturing. The highest industrial sales were measured in manufacture of electrical and optical equipment (22.0%). Industrial foreign-controlled enterprises raised their sales 5.1% at constant prices (2.5% at current prices), y-o-y.



Table No. 2: Industry sales in 2002

<b>INDUSTRY: SALES</b>				
	<b>Index</b>			
	October	November	December	January to December
<b>Industry of the CR</b>				
Sales				
Current prices	100.0	102.8	103.1	100.2
Constant prices of 2000	103.3	105.8	105.3	103.4
Direct exports sales				
Current prices	106.7	115.7	115.2	107.7
Constant prices of 2000	114.9	123.8	121.4	115.7

Source: www.czso.cz

**The number of employees** in December 2002 in the whole industry fell by about 48.9 thousand persons i.e. 4.1%, y-o-y. Decreases were recorded in the mainly industrial branches, namely in manufacture of textiles and textile products and mining and quarrying, while increases occurred in manufacture of rubber and plastic products and transport equipment. **The average monthly nominal wage** in December 2002 amounted to CZK 16 794 per employee in December 2002 and grew by 7.0% y-o-y. **Labour productivity** (sales per employee) was 9.8% up in December 2002. Unit wage costs were 2.6 percentage points down, y-o-y.

Table No. 3: Employment and wages in industry in 2002

	<b>Index</b>			
	October	November	December	January to December
<b>Industry of the CR</b>				
Average registered employment	96.3	96.0	95.9	97.1
Average monthly wage, nominal	105.8	103.7	107.0	106.0
real	105.2	103.2	106.4	104.1
Average hourly wage	108.1	106.1	104.1	106.3
Labour productivity	107.3	110.3	109.8	106.4

Source: www.czso.cz

### 1.3.6 Output, employment and productivity in year 2003

Compared with the average month of the base year 2000, **industrial production** in December 2003 was by 18.0% higher and grew by 8.9% year-on-year. Compared to November 2003, it went by 14.2% down. These indices are not adjusted for working days.

**Sales in industry** of the enterprises (legal and natural persons employing 20 people or more) reached in December 2003 108.7% or 106.2%, if working days adjusted (year-on-year at constant prices, 2000 average prices). There was one more working day in December 2003 compared to December 2002. 'Manufacture of rubber and plastic products' (38.3% up), 'manufacture of machinery and equipment' (23.6% up) and 'manufacture of transport equipment' (19.0% up) were responsible for the high growth of total sales in industry. The sales dropped most in 'manufacture of leather and leather products' (15.4% down) and 'mining and quarrying of energy producing materials' (5.3% down).

Table No. 4: Industry sales in 2003

	October	November	December	January to December
<b>Industry of the CR</b>				
Sales				
Current prices	105.0	100.5	109.4	105.4
Constant prices of 2000	104.4	99.6	108.7	105.4
Constant prices of 2000 2)	104.4	104.2	106.2	105.4
Direct exports sales				
Current prices	110.6	103.4	115.8	109.7
Constant prices of 2000	108.1	101.1	114.2	108.8

2) Adjusted for work days

Source: www.czso.cz

The **average number of employees** in the industry fell by 3.6% (41.9 thousand persons) y-o-y. The employment fell in most CZ-NACE activities, especially in ‘manufacture of leather and leather products’ and ‘manufacture of textile and textile products’, and increased in ‘manufacture of rubber and plastic products’ and ‘manufacture of electrical and optical products’ **Average monthly nominal wage** amounted to CZK 18 053, rising by 7.0% y-o-y. Average hourly wage stood at CZK 150.1 and rose by 1.9% y-o-y. Labour productivity (sales per employee) was by 12.8% up and unit wage costs down by 5.1% y-o-y.

Table No. 5: Employment and wages in industry in 2003

	October	November	December	January to December
<b>Industry of the CR</b>				
Average registered employment	96.0	96.3	96.4	96.7
Average monthly wage, nominal	105.7	106.5	107.0	105.7
real	105.3	105.4	105.9	105.6
Average hourly wage 2)	105.4	111.7	101.9	105.5
Labour productivity	108.7	103.5	112.8	108.9

2) Calculated as the ratio of the volume of wages cleared to the number of hours worked in a given period

Source: www.czso.cz

### 1.3.7 Output, employment and productivity in year 2004

Industrial production in December 2004 grew by 8.3% year-on-year. Compared with the average month of the base year 2000, **industrial production** in December 2004 was by 27.8% lower. Industrial production in December 2004 went down by 16.2% month-on-month. These indices are not adjusted for working days.

**Sales in industry** of the enterprises (legal and natural persons employing 20 people or more) were higher by 8.6% or 4.0% (WDA) in December 2004 (year-on-year at constant prices, 2000 average prices). There were two more working days in December 2004 compared to December 2003. High growth of ‘manufacture of electrical and optical equipment’ (+27.3%), ‘manufacture of transport equipment’ (+22.8%) and ‘manufacture of rubber and plastic products’ (+17.9%) contributed to the increase of total sales in industry.

Table No. 6: Industry sales in 2004

	October	November	December	January to December
<b>Industry of the CR</b>				
Sales				
Current prices	112.3	119.5	113.5	114.3
Constant prices of 2000	106.5	113.9	108.6	109.8
Constant prices of 2000 2)	111.2	108.8	104.0	109.4
Direct exports sales				
Current prices	116.8	123.0	119.8	119.7
Constant prices of 2000	114.5	121.4	118.4	117.0

2) Adjusted for work days

Source: www.czso.cz

The **average number of employees** in the industry dropped by 0.3% (-3.9 thousand persons) y-o-y. The employment fell most in 'manufacture of leather and leather products', 'manufacture of textiles and textile products' and 'mining and quarrying of energy producing materials', and increased in 'manufacture of transport equipment', 'manufacture of rubber and plastic products' and 'manufacture of electrical and optical equipment'. The **average monthly nominal wage** amounted to CZK 18 870, rising by 4.6% y-o-y. Unit wage costs were 3.9% down. The average hourly wage increased by 1.1% and stood at CZK 151.30. Labour productivity (sales per employee) was 8.9% up and productivity per hour grew by 5.3%.

Table No. 7: Employment and wages in industry in 2004

	October	November	December	January to December
<b>Industry of the CR</b>				
Average registered employment	100.1	99.9	99.7	99.5
Average monthly wage, nominal	104.8	108.5	104.6	106.9
real	101.3	105.4	101.8	104.0
Average hourly wage 2)	111.1	100.6	101.1	104.5
Labour productivity	106.4	114.0	108.9	110.4

2) Calculated as the ratio of the volume of wages cleared to the number of hours worked in a given period

Source: www.czso.cz

### 1.3.8 Output, employment and productivity in year 2005

**Industrial production in December 2005** grew by 7.1% year-on-year. Compared with the average month of the base year 2000, **industrial production** in December 2005 was by 36.8% higher. Industrial production in December 2005 went down by 16.2% month-on-month. These indices are not adjusted for working days.

**Sales in industry** in December 2005 (year-on-year at constant prices, 2000 average prices) reached 107.1% or 108.4% (working days adjusted). There was one working day less in December 2005 compared to December 2004. High growth of 'manufacture of transport equipment' (+20.0%), 'manufacture of machinery and equipment' (+11.7%) and

‘manufacture of rubber and plastic products’ (+10.3%) contributed to the increase of **total sales** in industry.

Table No. 8: Industry sales in 2005

	October	November	December	January to December
<b>Industry of the CR</b>				
Sales				
Current prices	107.2	108.9	106.9	108.0
Constant prices of 2000	109.5	111.3	108.4	108.1
Direct exports sales				
Current prices	104.9	105.9	104.0	106.8
Constant prices of 2000	108.8	110.2	106.7	110.2

Source: www.czso.cz

The **average number of employees** in the industry went up by 0.2% (+2.2 thousand persons) year-on-year. Year-on-year, employment increased in ‘manufacture of rubber and plastic products’, ‘manufacture of transport equipment’ and ‘manufacture of chemicals, chemical products’; and decreased most in ‘electricity, gas and water supply’, ‘manufacture of textiles and textile products’ and ‘mining and quarrying, except of energy producing materials’. The **average monthly nominal wage** rose by 3.7% year-on-year and amounted to CZK 19 629. The average hourly wage increased by 5.7% and was CZK 160.6. Labour productivity (sales per employee) increased by 8.2% and productivity per hour by 10.3%. Unit wage costs were down by 4.2%.

Table No. 9: Employment and wages in industry in 2005

	October	November	December	January to December
<b>Industry of the CR</b>				
Average registered employment	100.2	100.1	100.2	99.9
Average monthly wage, nominal	104.1	105.2	103.7	104.6
real	101.5	102.7	101.5	102.6
Average hourly wage 2)	102.7	105.7	105.7	105.2
Labour productivity	109.3	111.2	108.2	108.2

2) Calculated as the ratio of the volume of wages cleared to the number of hours worked in a given period

Source: www.czso.cz

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## 2 THE DEVELOPMENT OF FDI IN THE CZECH REPUBLIC

The attitude towards inward foreign direct investment (FDI) has changed considerably over the last couple of decades, as most countries have liberalised their policies to attract all kinds of investment. This paper aims to give a short overview of the development of foreign direct investment in the Czech Republic since 1993. The article is organised as follows. Short theoretical introduction is followed by the analysis of trends in the 90's and explanation of the steps taken by the government towards FDI. Activities of the promotion agency "CzechInvest" are mentioned as well. Final part gives the list details of the incentive scheme.

### 2.1 Foreign direct investment

To understand the focus of the paper, several definitions should be given at the very beginning.

*Foreign direct investment (FDI)* is defined as a long term investment by a *foreign direct investor* in an enterprise resident in an economy other than that in which the foreign direct investor is based. The FDI relationship, consists of a parent enterprise and a foreign affiliate which together form a multinational corporation (see below). In order to qualify as FDI the investment must afford the parent enterprise control over its foreign affiliate. The UN defines control in this case as owning 10% or more of the ordinary shares or voting power of an incorporated firm or its equivalent for an unincorporated firm.

A *multinational corporation (MNC)* is a corporation or enterprise that manages production establishments or delivers services in at least two countries. Multinationals have played an important role in globalization. Given their international reach and mobility, prospective countries, and sometimes regions within countries, must compete with each other to have MNCs locate their facilities within. To compete, countries and regional political districts usually offer incentives to MNCs such as tax breaks, pledges of governmental assistance or improved infrastructure.

### 2.2 Types of FDI

Further, the readers should familiarise themselves with the most usual types of FDI that occur in modern economies.

*Greenfield investment* - direct investment in new facilities or the expansion of existing facilities. Greenfield investments are the primary target of a host nation's promotional efforts because they create new production capacity and jobs, transfer technology and know-how, and can lead to linkages to the global marketplace. However, it often does this by crowding out local industry; multinationals are able to produce goods more cheaply (because of advanced technology and efficient processes) and uses up resources (labour, intermediate goods, etc). Another downside of greenfield investment is that profits from production do not feed back into the local economy, but instead to the multinational's home economy. This is in contrast to local industries whose profits flow back into the domestic economy to promote growth.

*Mergers and acquisitions* occur when a transfer of existing assets from local firms to foreign firms takes place, this is the primary type of FDI. Cross-border mergers occur when the assets and operation of firms from different countries are combined to establish a new legal entity. Cross-border acquisitions occur when the control of assets and operations is transferred from

a local to a foreign company, with the local company becoming an affiliate of the foreign company. Unlike greenfield investment, acquisitions provide no long term benefits to the local economy - in most deals the owners of the local firm are paid in stock from the acquiring firm, meaning that the money from the sale could never reach the local economy.

*Horizontal Foreign Direct Investment:* is an investment in the same industry abroad as a firm operates in at home.

*Vertical Foreign Direct Investment:* takes either the “backward” form (i.e. an industry abroad provides inputs for a firm's domestic production process) or “forward” form where an industry abroad sells the outputs of a firm's domestic production processes.

## 2.3 Involvement in international production

After the definition of the FDI and key players in the capital flows, we should explain, why business entities involve international production. It is the outcome of a process in which ownership, internalisation and localisation advantages work together. The ownership advantages are firm specific in the sense that the firm has control over them. They embrace patents, know-how, labour skills and other forms of superior production technology, control over markets and trade monopolies, scale advantages, managerial capabilities, etc. These factors determine the firm's competitive position in relation to other firms. The internalisation advantages arise from the existence of market imperfections, nature of markets, their weaknesses and limitations and organisation of firms. Location advantages are those associated to the availability of inputs for all firms established in a certain country. They comprise natural resources, location, cultural and political environment, factor prices, transport costs, but also government policies such as trade barriers (e.g. quotas, tariffs).

In order to compete successfully in a foreign market a firm must possess some assets in knowledge, technology, organisation as well as managerial and marketing skills. A firm blessed with such assets enjoys several possible ways to claim the rents that they will yield in foreign markets, including FDI, subsidiary production or joint ventures, licensing, franchising, management contracts, marketing contracts, and turnkey contracts.

## 2.4 Why do firms invest abroad?

Although no single theory could explain the existence of foreign direct investment, there is a strong consensus in the literature, why multinationals invest in specific locations.

MNCs are mainly attracted by strong economic fundamentals in the host economies. The most important ones are market size and real income levels, skill levels in the host economy, the availability of infrastructure and other resource that facilitates efficient specialisation of production, trade policies, and political and macroeconomic stability. The relative importance of the different fundamentals varies depending on the type of investment. For instance, foreigners investing in the United States have mainly been attracted by the large market size, while multinationals investing in Singapore focus on the availability of skilled labour, good infrastructure and political and macroeconomic stability.

The location of FDI may also be influenced by various incentives offered by governments to attract multinationals. These incentives take a variety of forms. They include fiscal incentives such as lower taxes for foreign investors, financial incentives such as grants and subsidies to MNCs. This drive to lure investment often extends to the sub-national level, with different regional authorities pursuing their own strategies and assembling their own baskets of incentives to attract new investments.

## 2.5 Policies to Attract Foreign Direct Investment

There is keen competition among countries to attract foreign direct investment. There are many methods used by policymakers to attract FDI and their effectiveness. These approaches include:

*Achieving political and economical stability* - only a minority of businessmen is willing to put money at stake. Hence, established democratic principles and sustainable political development as well as government's macroeconomic framework designed to maintain long term economic stability helps to increase confidence. Large fluctuations of output, inflation and employment add to uncertainty of firms and should be avoided.

Improving the *regulatory environment* - regulation is understood as a set of legal restrictions imposed by government administrative agencies through rulemaking supported by a threat of a sanction or a fine. Common examples of regulation include attempts to control market entries, prices, wages, pollution effects, employment for certain people (usually for disadvantaged groups), standards of production for certain goods and services.

*Decreasing red tape* - red tape is a derisive term for excessive regulations that are considered redundant or bureaucratic and hinder or prevent business-making. Red tape generally includes the filling out of unnecessary paperwork, obtaining of unnecessary licenses, having multiple people or committees approve a decision, and various low-level rules that make conducting business slower and/or more difficult.

Providing targeted *fiscal incentives*, such as tax concessions, grants and specific subsidies - see below for the situation in the Czech Republic.

Enhancing domestic *infrastructure* - this term refers broadly to facilities and related operations providing basic services to individuals and businesses, such as transportation, water supply, energy supply, and waste removal. The level of infrastructure significantly influences the investors' decisions to involve in the local economy. Non-existence or poor quality of transportation facilities (roads, highways, railroads, airports, shipping lines) prevents reliable supply of either raw material on input or finished goods on output. Equally, electricity, natural gas supply, coal delivery, water supply, sewers are essential for production. Other items can be taken into consideration, such as telephone service, radio and television broadcasts or postal systems. As managers of FDI enterprises often move in with their families, they are interested in things such as health care provision (including quality of hospitals) or school and education system.

Promoting *skills development* to meet investor needs and expectations - this encompasses any program that helps individuals to obtain skills necessary for employment. Investors are interested in the structure of the educational system (secondary education, vocational training, universities and colleges), continuing education schemes and retraining courses as well as the ability of educational institutions to stay in close touch with latest development of industry and develop skills and knowledge that are currently needed.

Establishing broad-reaching FDI *promotion agencies* - see the chapter focused on CzechInvest.

Engaging in *international governing arrangements* - this encompasses namely bilateral investment agreements. The Czech Republic is a member of the Multilateral Investment Guarantee Agency (MIGA), an international organization for protection of investment belonging to the World Bank-IMF group. To date, 70 countries have signed and ratified agreements with the Czech Republic. They include major investors: Australia, Austria, Belgium-Luxembourg, Bulgaria, Canada, China, Denmark, Finland, France, Germany,



Greece, Hungary, Israel, Indonesia, Italy, Jordan, Kazakhstan, Lebanon, North and South Korea, Mongolia, Norway, Paraguay, Poland, Russia, Slovakia, South Africa, Spain, Sweden, Switzerland, Thailand and the United Kingdom.

## 2.6 Investment climate in the Czech Republic

Maintaining an open investment climate has been a key element of the Czech Republic's transition from a Communist, centrally planned economy, to a functioning market economy. The Czech Republic's stable political and economic environment, its location on the doorstep of the European Union, its low cost structure and its well-qualified labour force make it an attractive destination for foreign investment. Prior to its accession to the European Union on May 1, 2004, the Czech government harmonized its laws and regulations with those of the European Union. The Czech economy has experienced moderate growth in the past few years. A rising government budget deficit could put continued growth at risk in the medium to long term, particularly if the current strong direct foreign investment flows slow down and European demand remains weak. The Czech government offers attractive incentives for foreign direct investment.

For several years, the Czech Republic has received more foreign direct investment per capita than any other country of the former Soviet bloc. Gross Domestic Product (GDP) has been growing recently (6.0% in 2005, and an estimated 5.6% in 2006), based largely on significant inflows of foreign investment and growing consumer demand supported in part by rising wages influenced by that investment. Foreign investment is boosting productivity, creating new jobs and raising wages and domestic consumption. It is also contributing to a trend of appreciation in the value of the local currency - the Czech crown (CZK). This phenomenon is helping to keep inflation low (1.9% in 2005, about 2.6% in 2006). Some unfinished elements in the transition, such as slow and uneven enforcement of contracts by the Czech courts, have affected investment, competitiveness, and company restructuring.

The government has harmonized most relevant laws with EU legislation and the so-called "acquis communautaire". This effort has involved positive reforms of the judicial system, civil administration, financial markets regulation, intellectual property rights protection, and many other areas important to investors. While there have been many success stories, a handful of investors have experienced problems, mainly in heavily regulated sectors of the economy such as the media and in enterprises where the state is a partner. Investors also complain about difficulties in enforcing contractual rights, including security interests. The slow pace of the court system is often compounded by judges' lack of familiarity with commercial cases. Needed reforms of the system for registering companies and the bankruptcy laws have been slow in coming. Concerns about corruption have been voiced by foreign and domestic businesses alike.

*Equal Treatment* is another component of the investment strategy. Legally, foreign and domestic investors are treated identically. Both are subject to the same tax codes and laws. The government does not differentiate between foreign investors from different countries, and does not screen foreign investment projects other than in the banking, insurance and defence sectors. Upon accession to the OECD, the Czech government agreed to meet (with a small number of exceptions) the OECD standards for equal treatment of foreign and domestic investors and limitations on special investment incentives.

*All sectors* of the Czech economy are open to foreign investment. Investors in banking, financial services, insurance and broadcast media sectors must meet certain licensing requirements. Some professions, such as architects, physicians, lawyers and tax advisors,

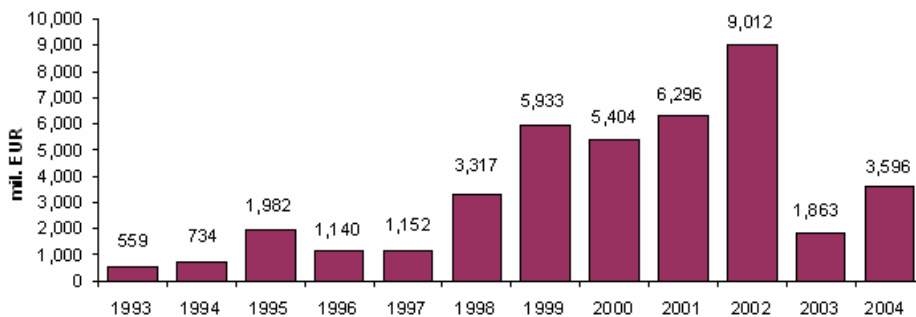
require memberships in the appropriate professional chamber. These licensing and membership requirements apply equally to foreign and domestic investors.

## 2.7 Inflow of FDI

The Czech Republic is one of the most successful transition economies in attracting foreign direct investment in the Central and East Europe. The introduction of investment incentives in 1998 has stimulated a massive inflow of FDI into both greenfield and brownfield projects and since 1993 more than EUR 46 billion in FDI has been recorded.

The privatisation of remaining government stakes in state-owned enterprises is expected to attract significant amounts of FDI and the major inflow of greenfield projects is expected to continue. The upswing in investment since 1998 is generally attributed to the introduction of investment incentives, as well as the Czech Republic's natural advantages.

Graph No. 3: Inflow of foreign direct investment to the Czech Republic (mil. Euro)



It is no surprise that major investors are coming from countries which are also the key trading partners and where there are traditional links. Hence the inflow is dominated by EU countries. However, overseas investors make a significant contribution too, i.e. Japan's investments are raising since its successful entry in 1995 (Matshusita TV company in Plzeň - Bory). See below for FDI inflow to the Czech Republic by country.

Table No. 10

Country	1993 – 2005	
	mil. EUR	%
Germany	12.678	27
Netherlands	7.038	15
Austria	4.532	10
France	3.641	8
Spain	2.979	6
United States	2.855	6
Belgium	2.082	4
Switzerland	2.053	4
United Kingdom	1.832	4
Japan	847	2
Sweden	607	1
Denmark	471	1
Italy	453	1
Canada	283	1
Other	4.299	9
Total	46.649	100

Source: author

In addition to the overview of investors, brief information on sectors is provided. Traditionally, manufacturing and engineering has a long history in Bohemia and Moravia, hence the investors have been using the capacity and skills that already existed.

Table No. 11

	1993 - 2005	
	mil. EUR	%
Manufacturing		
Machinery and equipment	6.235	41
Basic metals and metal products	2.246	15
Refined petroleum and chemicals	2.088	14
Food and tobacco	1.663	11
Non-metallic products	1.395	9
Other	1.521	10
Total	15.147	100

Source: author

Table No. 12

	1993 - 2005	
Non-manufacturing		
Financial intermediation	8.466	27
Transport, storage, communications	7.854	25
Trade, hotels and restaurants	5.548	18
Real estate, business activities	4.750	15
Electricity, gas, and water supply	2.514	8
Other	2.370	8
Total	31.502	100

Source: author

## 2.8 CzechInvest

The main objective of CzechInvest is to advise and support new and existing entrepreneurs and foreign investors in the Czech Republic.

CzechInvest, the Investment and Business Development Agency, is an agency of the Ministry of Industry and Trade. Established in 1992, the agency contributes to attracting foreign investment and developing domestic companies through its services and development programmes. CzechInvest also promotes the Czech Republic abroad and acts as an intermediary between the EU and small and medium-sized enterprises in implementing structural funds in the Czech Republic.

The headquarters of CzechInvest is located in Prague and Czech worldwide representations are situated in Europe, USA, Southeast Asia and Japan.

CzechInvest is authorized to file applications for investment incentives at the competent governing bodies and prepares draft offers to grant investment incentives. Its task is also to provide potential investors with current data and information on business climate, investment environment and investment opportunities in the Czech Republic.

*CzechInvest's services* (all CzechInvest's services are free of charge):

- comprehensive services for investors
  - full information assistance
  - handling of investment incentives
  - business properties identification
  - supplier identification
  - aftercare services
- business infrastructure development
- access to structural funds

Throughout its existence CzechInvest has already taken part in 605 investment projects worth over 15 billion dollars in total. Owing to these investments, almost 125 thousand direct jobs are to be gradually created. For more information about CzechInvest, see its web page: <http://www.czechinvest.org>

## 2.9 Investment incentives

In 1998 the Czech government approved a package of incentives to attract investment. The incentives are offered to foreign and domestic firms that make a 100/200<sup>1</sup> mil. CZK manufacturing investment through a newly registered company. The package includes relief from corporate taxes for up to ten years, job-creation grants, re-training grants and opportunities to obtain low-cost land. A tax incentive is also available for expansion of an existing manufacturing investment.

Additional incentive package has been approved for operations with high-added value. Subsidies are offered for services centres for software development, customer service and repairs. More recently, subsidies to attract high technology and research and development centres have been added. Tax deductions for new machinery, real estate tax relief, job creation grants, re-training grants, simplified customs procedures and duty-free import of machinery are also available under certain conditions to qualified companies. The incentives were developed with the assistance of the EU in order to ensure their compatibility with EU rules on industrial subsidies. Therefore, there has been no change to the incentive program as a result of the Czech Republic's accession to the European Union.

## 2.10 Manufacturing

The investment incentives *Act No. 72/2000 Coll.*, as amended, is valid as of 1st May 2004 and offers both Czech and foreign investors who are introducing new production or expanding existing production the following incentives. Here is the list of offered incentives.

### **Corporate tax relief:**

- *Full tax relief* for 10 years (newly established companies)
- *Partial tax relief* for 10 years (expanding companies)

### **Job-creation grants:**

- 200,000 CZK per employee in the district "I"<sup>2</sup>
- 100,000 CZK per employee in the district "II"

### **Training and re-training grants:**

- 35% of the costs of the training in the regions where the unemployment rate is higher than the country's average (I, II, III) The total amount of the aforementioned investment incentives (with the exception of training and re-training) must *not exceed 50%* (65% in the case of SMEs) of the investment made into long-term tangible and intangible assets.

Zone I includes regions with the highest unemployment in the Czech Republic, i.e. namely the North Bohemia (e.g. Most) and North Moravia regions (Ostrava). It is followed by zone II (e.g. Svitavy or Sokolov) and zone III (Karlovy Vary, Břeclav).

## 2.11 Technology Centres and Business Support Services

The *Framework Programme* for support of Technology centres and Business Support Services has been valid since 17th February 2004. The government understands that it is

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<sup>1</sup> based on the average unemployment rate

<sup>2</sup> see the map of districts which is available at CzechInvest webpage and examples below

important to bring not only simple manufacturing companies but also operators delivering high added value and utilising the skilled labour force available. The support is divided between the TCs and BSS.

*Technology centres* are innovation activities especially involved with periodic changes of products and technologies and are closely linked to production. *Business support services* are services with high added value and support employment of qualified experts in software development centres, expert solution centres, high-tech repair centres, shared services centres, centres of customer support (e.g. call – centres) and regional headquarters).

### Forms of support

- *subsidy to business activity*
  - up to 50% of the eligible costs, which are:
    - investment into tangible and intangible fixed assets purchased within the first 5 years **or**
    - two-year salaries of employees employed within the first 3 years
- *subsidy for training and re-training*
  - subsidy up to 35% of the specific training costs and 60% of the general training costs; maximum subsidy of 100,000 CZK or 150,000 CZK for one job position depending on the number of job positions created.

Table No. 13

Eligibility criteria		
<i>Type of project</i>	technology centres software development centres expert solution centres headquarters	call centres high-tech repair centres shared services centres (except headquarters)
<i>Minimum investment</i>	15 mil. CZK	30 mil. CZK
<i>Minimum number of newly created jobs</i>	15	50
<i>Amount recipient must finance with own resources</i>	7.5 mil. CZK	15 mil. CZK
<i>Linkage with production (relevant for TC only)</i>	The results of the Technology Centre should be materialized in production	

Source: author

## 3 LEGAL FRAMEWORK FOR CZECH COMPANIES

### 3.1 Czech Law

Czech law is Continental based law. In view of the historic links to the Habsburg monarchy and the influence of the neighbouring Germany, Czech law is strongly influenced by German and Austrian law. After the fall of the Communist regime, however, the country's legal system was subject to a significant influence from other countries and legal systems, including Anglo-Saxon law. Before the Czech Republic entered the European Union, there was an extensive legislative process - harmonisation of the Czech legal system with the legal system operating in the EU. As part of the harmonisation process, a number of new legal regulations, compatible with European regulations, were adopted, with simultaneous changes to existing legal regulations in order that they conform to the binding legal regulations for Union members states.

The Czech Commercial law includes several Essentials codes (laws) dependless on the nature of business activities. These codes are:

- The Commercial Code
- The Small Businesses Act (Code)
- Tax Laws (separate for legal and natural persons)
- The Law on Accounting
- The Health and Social Insurance Laws
- The Labour Code.

### 3.2 Natural and Legal Entities

Czech law makes a distinction between natural and legal entities (persons). In the case of natural entities, the competency to have rights and obligations commences at birth, but the competency to acquire rights and take on obligations by ones own acts (competency to perform legal acts) arise in full upon the person reaching maturity (18 years). In comparison legal entities derive their competency to rights and obligations, but also to legal acts by derivation as they are not "living" and are created artificially.

#### 3.2.1 Legal entities

The Commercial Code provides for the creation of several different types of business entities, they can be divided into two main groups:

1. Capital companies:
  - a) Limited liability company
  - b) Joint stock company
2. Partnerships:
  - a) General commercial partnership (unlimited partnership)
  - b) Limited partnership (commandite company)
3. Cooperatives.

Legal entities also includes:

- associations of natural or legal entities,
- purposeful asset associations,
- municipalities,
- other subjects, as prescribed by law.

### 3.2.2 Natural entities (Sole proprietor, entrepreneur)

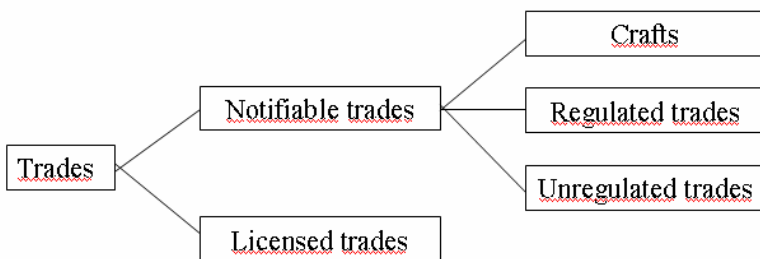
As stated in the Small Business Act „Individuals can carry on business activities in their own name on their own risk with the purpose to achieve profit, and on the basis of a valid trade licence and according to law(s)“. In the case of a foreign individual, entry in the Commercial Register is also required.

## 3.3 Trades

For the majority of business activities in the Czech Republic, a trade certificate is required for both legal and natural entities. The conditions are given in the Small Business Act as well as the definition of different types of trades, for which the applicant (in case of legal entities a statutory representative or representatives) or his statutory representative must fulfil the following basic general requirements:

1. a minimum age of 18 years,
2. legal competence to perform legal acts,
3. trustworthiness (not being convicted for intentional crime act for more than 1 year or other crime act connected with the craft or some casual act connected with the craft),
4. In addition to this, recent bankruptcy or a ban on practising a trade act as impediments and subject cannot have any tax debts.

Trades can be divided into several categories:



Trade certificate easiest to obtain is the notifiable trade. The appropriate Department of Trades Licensing, based on the address, must be notified, and a trade certificate will be issued, provided that the requirements have been met. The time limit is 15 days from notification.

1. **Notifiable trades** can be divided into the following categories:



- **Crafts**, for which it is necessary to have either certificate of apprenticeship or a certificate of finished secondary or higher education,
  - **Regulated trades** – a trade license can be acquired once the conditions according to the type of business activity have been fulfilled.
  - **Unregulated trades** can be practised by those without professional qualifications, but the general requirements (mentioned above) must be fulfilled.
2. For a **licensed trade** to be practised, a concession **trade license** must be acquired at the Trades Licensing Office and can only be practised by those who possess professional qualifications, as specified in appendix 3 of the Small Businesses Act (these trades include firearms handling, taxi services, disinfection, desinsection, deratization and rat extermination, toxic waste liquidation, etc.).

Many expatriates resident in the Czech Republic choose to start their own businesses. In the case of a foreign individual, entry in the Commercial Register is also required. For foreigners there are two ways to run their own business in the Czech Republic. They can operate either as a natural person or to set up a company (s.r.o.). Quite a lot of documents are required in both cases, especially in the case of setting up a company.

### 3.4 Legal entities

From the viewpoint of business activity, commercial companies undoubtedly play the most significant role. The most frequently used types of legal entities are limited liability companies and joint stock companies.

Table No. 14: Legal entities: by selected legal form

Legal form	Legal entities							
	1995		2000		2002		2004	
	Number	%	Number	%	Number	%	Number	%
<b>Registered legal persons, total</b>	<b>196 434</b>	<b>100,0</b>	<b>370 601</b>	<b>100,0</b>	<b>389 480</b>	<b>100,0</b>	<b>406 295</b>	<b>100,0</b>
<i>Business companies and partnerships, total</i>	112 514	57,3	204 075	55,1	214 637	55,1	220 461	54,3
<i>General commercial partnerships</i>	5 879	3,0	7 489	2,0	7 629	2,0	7 729	1,9
<i>Limited liability companies</i>	98 558	50,2	181 819	49,1	191 476	49,2	196 772	48,4
<i>Joint-stock companies</i>	7 564	3,9	14 092	3,8	14 845	3,8	15 260	3,8
<i>State-owned enterprises</i>	2 270	1,2	1 117	0,3	1 054	0,3	995	0,2
<i>Cooperatives</i>	6 172	3,1	11 007	3,0	11 536	3,0	12 085	3,0
<i>Foundations</i>	4 351	2,2	5 360	1,4	3 641	0,9	2 542	0,6
<i>Budgetary organizations <sup>1)</sup></i>	1 217	0,6	857	0,2	496	0,1	500	0,1
<i>Semi-budgetary organizations</i>	2 973	1,5	3 100	0,8	4 445	1,1	5 596	1,4
<i>Schools, school and health establishments</i>	5 297	2,7	5 521	1,5	4 392	1,1	3 626	0,9
<i>Associations of natural persons, associations of legal entities</i>	43 473	22,1	80 450	21,7	85 167	21,9	89 178	21,9
<i>Other</i>	18 167	9,2	59 114	16,0	64 112	16,5	71 312	17,6

<sup>1)</sup> Budgetary organization before 2001

Source: www.czso.cz

### **3.4.1 Commercial registration**

Commercial registration is obligatory for Czech legal entities (companies) and also for branches of foreign companies. Each company must follow certain procedures:

1. To obtain a trade licence authorising the entity to carry on business, it must nominate an individual to hold the trade licence.
2. One or more statutory representatives must be appointed.
3. If there are minimum capital requirements, a shareholder or a bank must be appointed as the administrator of contributions and must confirm that the required share capital has been paid up.

Business activities can commence as soon as the entry in the Commercial Register has been made.

The Commercial Register is available at the commercial courts (you can look at the records and make copies for a fee) or for free on the internet ([www.justice.cz](http://www.justice.cz)).

For getting basic information on Czech companies in English, the Business Register managed by the Czech Statistical Office is available at [www.czso.cz/eng/res/registr.htm](http://www.czso.cz/eng/res/registr.htm)

### **3.4.2 Limited liability company**

Up to 50 individuals or legal entities (known as "shareholders" or "partners") can establish a limited liability company. If there is a single founding partner, a notarised foundation deed is required. Where there are two or more founding partners, a memorandum of association is drawn up in the form of a notarial deed. A limited liability company with a single partner may not be a founder or partner of another limited liability company (with the exception of entities under centralised management - i.e. within a holding group). One individual (natural person) may be a single partner of a maximum of three limited liability companies. A limited liability company is not required to have a Czech statutory audit in its first year. In subsequent years, a statutory audit is necessary if turnover in the previous year exceeded CZK 40 million, or net assets exceed CZK 20 million. The liability of each of the partners is limited to the total of the unpaid parts of all partners' contributions to the registered capital as registered in the Commercial Register.

#### **Registered capital requirements**

The minimum registered capital for a limited liability company is CZK 200,000 and each partner is required to invest at least CZK 20,000. At least 30% of each partner's monetary investment must be paid-up before the company can be entered in the Commercial Register. The minimum total value of these deposits is CZK 100,000. All non-monetary capital contributions must be paid-up before entry in the Register. If a single entity establishes the company, the registered capital must be fully paid-up before the company can be entered in the Commercial Register.

#### **Reserve fund**

As with joint-stock companies, limited liability companies must establish reserves, which must be at least 10% of the registered capital. Details of the size and method of establishing the reserve fund must be set out in the memorandum of association. If the fund is not created on incorporation, it must be established in the company's first profitable year as a minimum of 10% of the net profit, but not more than 5% of the registered capital. Subsequently, the fund must be increased annually by at least 5% of the net profit until the level specified in the memorandum of association is reached. This must be at least 10% of the registered capital.

## Management

- General meeting

The general meeting is the supreme body of a limited liability company. It has rights similar to those of the general meeting of a joint-stock company.

- Statutory representatives (executives)

The general meeting appoints one or more executives who must be either Czech nationals or foreign individuals with Czech residency visas. No board of directors is required.

- Supervisory board

A supervisory board may be established for a limited liability company, but is not mandatory. It must have at least three members.

Table No. 15

Advantages	Disadvantages
Limited liability of partners Low capital requirements Most commonly used form of legal entity	Less credible for partners (banks, creditors, suppliers) More administratively demanding for start-up entrepreneurs Double-entry accounting is required

Source: author

### 3.4.3 Joint-stock company

A joint-stock company can be set up by a single legal entity, two or more legal entities or by individuals. It can be established either by:

- the original founder(s) subscribing shares while complying with certain formalities, e.g. obtaining a notarised deed recording the establishment of the company, approving its rules and appointing members of the company's statutory bodies; or
- inviting other investors to subscribe shares, in which case a formal meeting of both the original founders and potential investors is required.

Joint-stock companies must have an annual Czech statutory audit.

#### Share capital requirements

The minimum share capital requirement is CZK 2 million for companies set up without a public offer for share subscription and CZK 20 million for companies set up with a public offer for share subscription. An authorised valuer must value non-monetary capital contributions. Two valuers are required if the non-monetary contribution is in the form of know-how or all or part of a business exceeds CZK 10 million in value, or where there is only one investor. The share capital must be fully subscribed before entry in the Commercial Register, with at least 30% of monetary contributions and 100% of non-monetary contributions paid-up.

A joint-stock company can issue either registered shares or bearer shares. The shares may be issued either in certificated or uncertificated (paperless) format. Certificated registered shares are transferable by endorsement, the transfer being affected by entry in the company's share

register. Certificated bearer shares are freely transferable on delivery. For a transfer of uncertificated shares, registration in the Securities Register is required. The ability to transfer registered shares can be restricted by a company's statutes. There is no minimum amount or other limitation on the value of shares. A company's statutes may enable employees of the company to acquire ordinary shares of the company under preferential conditions. If only a part of the issue price or purchase price for such shares is paid by the employees, the total of the unpaid parts of the price cannot exceed 5% of the company's share capital.

Preference shares may be issued up to a maximum of 50% of the company's share capital. Non-voting preference shares may also be issued. The issue of interest-bearing shares, whose yield is not related to the company's performance, is not permitted.

### **Reserve fund**

All joint-stock companies are required to establish reserves of at least 20% of their share capital. Details of the size and method of establishing the reserves are set out in the company's statutes. The reserve fund can be created on incorporation or, at the latest, in the company's first profitable year when it must equal at least 20% of net profit, but not more than 10% of the share capital. Subsequently, the fund must be increased annually by at least 5% of net profit up to the level specified in the company's statutes, which cannot be less than 20% of the share capital.

### **Management**

The formal bodies of a joint-stock company are the general meeting, board of directors and supervisory board. An individual cannot simultaneously be a member of both the board of directors and the supervisory board at any one time.

### **General meeting**

The general meeting is a joint-stock company's supreme body. It can amend the company's statutes, approve changes to share capital, elect and reappoint members of the board of directors and supervisory board, approve financial statements and profit allocations and wind up the company. If there is only one shareholder, it has the same powers as the general meeting. A simple majority is sufficient for most decisions. However, a two-thirds majority is required to approve changes to share capital, amend the company's statutes or dissolve the company by liquidation. A majority of three-quarters is needed to change the class, type, or underlying rights of shares, restrict the transferability of registered shares or cease public trading of the shares.

### **Board of directors**

The general meeting elects a board of directors for a maximum of five years. The board must have at least three members who are either Czech nationals or foreign individuals with Czech residency visas. It oversees the day-to-day running of the company and is responsible for maintaining proper accounting and reporting procedures. Board members act and sign on behalf of the company, within the guidelines approved by the general meeting.

### **Supervisory board**

A joint-stock company must have a supervisory board of at least three members elected by the general meeting for a maximum of five years. If the company has more than 50 employees, the employees must elect one-third of the members. The board monitors the activities of the directors and the performance of the company, and reviews the annual financial statements.

Table No. 16

Advantages	Disadvantages
shareholders are not liable solid image higher level of control	capital requirements higher administrative costs administratively demanding (longer decision making process, etc.)

Source: author

#### **3.4.4 General commercial partnership (unlimited partnership)**

Two or more individuals or legal entities (partners) can establish unlimited partnership. All partners must draw up a partnership agreement. In an unlimited partnership, all partners are jointly and severally liable for the partnership's obligations. Partnership profits are shared equally unless otherwise specified in the partnership agreement. Any partner can act on behalf of the partnership, unless otherwise stipulated. To act for either type of partnership as a statutory body, a partner must either be a Czech resident or a foreign individual with a Czech residency visa. Individuals meeting the same requirements can act for legal entities which are partners. Unlimited partnerships are not required to have a Czech statutory audit.

#### **3.4.5 Limited partnership (commandite company)**

Limited partnerships must have both general and limited partners. Two or more individuals or legal entities (partners) can establish a limited partnership. All partners must draw up a partnership agreement. General partners are jointly and severally liable for the unlimited partnership's obligations (as in a general partnership). The liability of limited partners is restricted to the unpaid part of their investment as registered in the Commercial Register (as in a limited liability company). For that reason, this type of legal entity is also called "a hybrid company". Each of the general partners can act in the limited partnership's name, unless the partnership agreement states otherwise.

#### **3.4.6 Co-operative**

A co-operative must have five or more individual members, or at least two members that are legal entities. Provided that these requirements are met, members may join or leave the co-operative without affecting its status. There is no maximum number of members. The minimum initial capital is CZK 50,000. At least half of the registered capital must be paid-up before entry in the Commercial Register. The members are not liable for the co-operative's obligations, unless the co-operative's statutes state otherwise. When the cooperative is established, an 'indivisible fund' must be created in the amount equivalent to at least 10% of the registered capital. Subsequently, the fund must be increased annually by a minimum of 10% of the net profit until the level set out in the co-operative's statutes is reached. This must be at least 50% of the registered capital.

The co-operative's supreme body is the members' meeting, which is held at least annually. It elects the board of directors to manage the day-to-day affairs of the co-operative and act on its behalf, in accordance with decisions made during the members' meeting. The members' meeting also elects an audit commission to perform regulatory and ombudsman functions. Unless otherwise stated, a 'one member, one vote' system applies.

### **3.4.7 Other types of business entities**

#### **3.4.7.1 Silent partnership**

A silent partnership is established by a written contract between a silent partner and a Czech legal entity, under which the silent partner invests in a company in return for a share of profit. A silent partner can be either an individual or a legal entity. With the exception of immovable property or unless otherwise stated in the contract, the silent partner's investment is the property of the Czech business. Silent partners are only liable for losses to the extent of their original investment.

#### **3.4.7.2 Associations**

Two or more individuals or legal entities can establish an association, which is not considered as a sole legal entity under Czech law and members are jointly and severally liable for obligations arising from the association's activities. Profits and losses are shared equally, unless the agreement specifies otherwise. Members may leave at any time.

#### **Conclusion**

The commercial law is completely harmonised with the EU legislative and the legal framework provides relatively wide space for business activities, partially concerning the variety of legal entities forms. The opportunities for foreigners to perform business activities in the Czech Republic have also improved with the accession of the Czech Republic to the European Union. Further, the number of legal entities, particularly the limited liability companies, which are the most frequent form, has increased.

## 4 THE CZECH ACCOUNTING SYSTEM AND ITS RELATIONSHIP WITH IAS (IFRS)

Accounting plays an important role in economic and social system of the Czech Republic as well as in the economic system of enterprises. Accounting is often called the "language of business." This language can be viewed as an information system that provides essential information about financial activities of an entity to various individuals or groups for their use in making informed judgments and decisions. As such, accounting information is composed principally of financial data about business transactions, expressed in terms of money. Accounting provides the techniques for gathering economic data and the language for communicating these data to different individuals and institutions.

Accounting can be divided into two basic systems:

1. Financial accounting,
2. Managerial accounting.

Financial accounting is concerned with the measuring and recording of transactions for a business enterprise or another economic unit and the periodic preparation of various reports from such records. The reports, which may be for general purposes or for a special purpose, provide useful information for managers, owners, creditors, governmental agencies, and the general public<sup>3</sup>.

Managerial accounting employs both historical and estimated data, which the management uses in conducting daily operations and in planning future ones. For example, in directing day-to-day operations, management relies upon accounting to provide information concerning the amount owed to each creditor, the amount owed by each customer, and the date each amount is due. The treasurer uses these data and other data in the management of cash. Accounting data may be used by the top management in determining the selling price of a new product. Production managers, by comparing past performances with planned objectives, can take steps to accelerate favourable trends and reduce those trends that are unfavourable.

### 4.1 The Czech accounting system

The Czech accounting system is regulated by several juridical laws.

The basic law is the law no. 563/1991 – LAW ON ACCOUNTING that constitutes the obligation to keep accounting files for the Czech enterprises. The Law on Accounting primarily defines the basic conditions and procedures for keeping of accounting evidence. Some paragraphs of the Law are relatively brief and for their practical usage it is necessary to specify them more precisely. This is the reason why the Law on Accounting is developed further by the Decree of Ministry of finance no. 500/2002 that constitutes the methods and principles of accounting as well as valuation rules. The Decree no. 500/2002 is further developed by the Czech accounting standards, valid since the beginning of the year 2004, describing specific accounting principles for specific economic transactions in detail.

These three basic laws regulate directly the accounting procedures. However, there are a lot of other laws and regulations in the Czech Republic that are connected with accounting indirectly – for example the Law on Income Taxes, the Law on Health and Social Insurance, etc.

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<sup>3</sup> WARREN, C.S., FESS, P.E.: *Financial accounting*, p. 15.

## 4.2 Accounting systems in the Czech Republic

There are two basic “accounting” systems in the Czech Republic:

1. Tax evidence of incomes and expenditures
2. Double-entry accounting

Tax evidence of incomes and expenditures can be used only by natural persons who are not in the trade register and whose turnover does not exceed the amount of 15 mil. CZK per year (turnover means amount of total revenues in accordance with the value-added tax act). The tax evidence is regulated primarily by income taxes act. This is the reason why the tax evidence of incomes and expenditures is not considered as a real accounting system. Accounting in the real form is regulated by the accounting regulation.

Business units defined by the accounting act must obligatorily keep accounting files in accordance with the “double-entry accounting system”. Double-entry accounting system means that all economic transactions are charged on two different accounts. The accounting act is applied on the “accounting units” defined by § 1 of the accounting act. In accordance with this regulation, particularly the following units are defined as accounting units in the Czech Republic:

1. Corporations (domestic corporations with the residence in the Czech Republic as well as foreign corporations doing business in the Czech Republic),
2. Natural persons doing business and registered in the trade register<sup>4</sup>,
3. Natural persons doing business with turnover exceeding amount 15 million CZK per year (turnover means amount of total revenues (or incomes) per year (with several exceptions) in accordance with the Law no. 235/2004 on Value-Added Tax).
4. Natural persons doing business who keep the accounting voluntarily,
5. Natural persons doing business and associated in an “association without legal subjectivity” under condition that any person associated in the association is an accounting unit<sup>5</sup>.
6. Other natural persons doing business whose obligation to keep accounting results from a special legal regulation.

## 4.3 Financial statements in the Czech Republic

All accounting units keeping double-entry accounting must obligatorily compile three basic financial statements providing basic information about economic and financial situation of the enterprise. These statements are:

1. Balance sheet
2. Profit and loss statement (income statement),
3. Appendix.

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<sup>4</sup> The trade register is a list of business units kept by trade courts in the Czech Republic. Obligatorily registered units are corporations and those natural persons who have entered it voluntarily or because of a special legal regulation.

<sup>5</sup> This regulation means that if one member of the association becomes an accounting unit, other persons become accounting units too.



The balance sheet is the most important financial statement compiled in the system of double – entry accounting. It provides information about the structure of assets and equities. The structure of the balance sheet valid in the Czech Republic is as follows:

**Assets**

**Equities**

<p><b>1. Fixed assets</b> intangible assets tangible assets long-term financial assets</p> <p><b>2. Current assets</b> inventories long – term receivables short – term receivables short – term financial assets</p>	<p><b>1. Owner’s equity</b> common stocks capital funds funds created from net profit economic results</p> <p><b>2. Liabilities</b> reserves long – term debts (liabilities) short – term debts (liabilities) bank credits (loans)</p>
<p>Σ Assets</p>	<p>Σ Equities</p>

The balance sheet does not provide information about other basic accounting categories – costs (expenses) and revenues. These items are included in the profit and loss statement (income statement). Revenues and costs are important, because they directly influence the economic result of the enterprise:

**Economic result = Revenues – Costs (Expenses)**

The excess of the revenue over the costs incurred in earning the revenue is called net profit (earnings after taxes). If the costs of the enterprise exceed the revenue, the excess is a net loss.

The revenue is defined as the result (output) of the economic activity of the enterprise achieved by spending of costs. Revenues give sense to economic existence of the enterprise. The revenue can influence assets (increasing of assets) or equities (decreasing of equities).

The cost is defined as the input into the economic activity of the enterprise with the aim to achieve revenues (outputs). The cost can influence assets (decreasing of assets) or equities (increasing of equities).

Costs and revenues are charged on special accounts in the double-entry accounting system. Systematically they are recorded in the profit and loss statement (income statement) (P/L Statement).

The structure of the P/L statement is a little more complicated than the structure of the balance sheet. The P/L statement is put together gradually with the aim to calculate several partial indicators representing individual parts of the economic activity of the enterprise.

The Appendix is the third obligatory statement compiled as a part of final accounts in the Czech Republic. It provides additional information about financial situation of the enterprise including information about the items in the balance sheet and profit and loss statement. The appendix also provides additional information about the accounting unit (name, seat, management, etc.).

## 4.4 The European accounting system

The European accounting system is a little different than the Czech accounting system. The European accounting system is based on the following:

1. Directives of the European Union,
2. International Accounting Standards (IAS). The newer term for IAS is International Financial Reporting Standards (IFRS).

The Czech accounting legislation has already accepted a lot of concepts embedded in IAS and Directives with the aim to synchronize the Czech and European juridical rules. The need for European accounting harmonization arose from the formation of the EU in 1957 and it is anchored in its foundation treaty (the Treaty of Rome). The harmonization itself has worked as an acceptance and transformation of European directives that were adopted by the European Council of Ministers. European directives do not have a character of international acts but they are required to be accepted as a part of national legislations of the EU members.

Since the formation of the EU in 1957 13 Directives have been issued. The most important Directives from the accounting point of view are:

1. Fourth Directive – was adopted in 1978. This Directive focuses on the unification of financial statements in member countries of the EU.
2. Seventh Directive – was adopted in 1983. This Directive concerns compilation of consolidated financial statements that must be compiled by groups of enterprises (holdings, concerns, etc.)
3. Eighth Directive – was adopted in 1984 and determines the minimal requirements for auditors' qualification.

## 4.5 The International Accounting Standards (IAS), the International Financial Reporting Standards (IFRS)

The International Accounting Standards (or International Financial Reporting Standards) represent the other basis pillar of the European accounting system. The IAS are issued by The International Accounting Standards Committee (IASC). The IASC came into existence on 29 June 1973 as a result of an agreement by accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK and Ireland and the USA. The objectives of IASC are set out in its Constitution. These objectives are:

1. To formulate and publish, in the public interest, accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance, and
2. To work generally for the improvement and harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements.

Since the most important accounting information is always provided in the financial statements, the IAS give them special attention and define their basic objectives. The main objective of the financial statements in accordance with IAS (IFRS) is:

*To provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. Financial statements prepared for this purpose must meet the common needs of most users.*

Financial statements also show the results of the stewardship of management, or the accountability for the resources entrusted to it.

To date 41 International Accounting Standards and 5 International Financial Reporting Standards have been accepted<sup>6</sup>. Particularly International Accounting Standard no. 1 is significant for the purpose of this chapter. **International Accounting Standard no. 1 – Presentation of financial statements** focuses on the financial statements obligatorily compiled by accounting units that are using IAS. The objective of this Standard is to prescribe the basis for presentation of financial statements, in order to ensure comparability both with the enterprise's own financial statements of previous periods and with the financial statements of other enterprises. To achieve this objective, IAS 1 sets out the overall considerations for the presentation of financial statements, guidelines for their structure and minimum requirements for the content of financial statements. IAS 1 further defines the purpose of financial statements. This purpose is defined as follows: „Financial statements are a structured financial representation of the financial position and of the transactions undertaken by an enterprise”. In accordance with IAS 1 the financial statements should provide information about:

- Assets,
- Liabilities,
- Equity,
- Income and expenses, including gains and losses,
- Cash flows.

A complete set of financial statements includes the following components (according to IAS 1):

- Balance sheet,
- Income statement (P/L statement),
- A statement showing either:
  - All changes in equity, or
  - Changes in equity other than those arising from capital transactions with owners and distributions to owners,
- Cash flow statement,
- Accounting policies and explanatory notes.

As a minimum the balance sheet should include these items:

- Property, plant and equipment,
- Intangible assets,
- Financial assets,
- Investments accounted for using the equity method,
- Inventories,
- Trade and other receivables,
- Cash and cash equivalents,

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<sup>6</sup> IFRS and IAS summary can be found at [www.iasb.org/standards/summaries.asp](http://www.iasb.org/standards/summaries.asp).

- Trade and other payables,
- Tax liabilities,
- Provisions,
- Non-current interest-bearing liabilities,
- Minority interest,
- Issued capital and reserves.

As a minimum the income statement should include these items:

- Revenue,
- The results of operating activities,
- Finance costs,
- Shares of profits and losses of associates and joint ventures,
- Tax expense,
- Profit or loss from ordinary activities,
- Extraordinary items,
- Minority interest,
- Net profit or loss for the period.

Furthermore, IAS and IFRS regulate other areas of financial accounting (for example inventories, cash-flow statements, revenues, etc.). Some enterprises in the Czech Republic (companies whose securities are traded on public financial markets) must obligatorily keep two kinds of accounting (accounting based on the Czech accounting legislation and accounting based on IAS/IFRS).

## 4.6 IAS and their relationship with Czech national accounting standards

Some significant tendencies and trends can be identified in the relationship between IAS (IFRS) and the Czech accounting legislation. The most significant trends are:

- The Czech national standards accept IAS (IFRS) more and more,
- It is expected that IAS (IFRS) will be completely integrated into the Czech legislation in the very near future,
- IAS and US GAAP (US General Accepted Accounting Principles<sup>7</sup>) will probably become the base for a united accounting system acceptable for all countries in the future.

From the worldwide perspective it is expected that only one system of accounting will remain in the future. This system will probably be created as a combination of IAS (IFRS) and US GAAP.

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<sup>7</sup> US GAAP constitute the basic accounting principles used in the U.S.

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## 5 STRATEGIC PARTNERSHIPS

### 5.1 Introduction

More and more we encounter company goals defined as reaching the competitiveness, increasing innovativeness or creating value for the customers. Both practitioners and academics try to find the best way to reach these goals with respect to sharpening the competition on the market.

99.8 % of all Czech enterprises are represented by the small and medium enterprises (SME's), which employ over 60 % of all the employees in the national economy. Considering the disadvantages, SME's can join the strategic partnerships and increase the competitiveness not only on the national but also on the foreign market (strategic partnerships with foreign partners). And conversely, foreign enterprises can expand their activities to the national (Czech) market with the help of their national (Czech) partners. Ability to compete in the EU can be acquired by cooperation with other companies around even if they are competitors.

Strategic partnerships are not suitable for SME's only. There is a tendency toward outsourcing of the internal processes, which contributes to the flexibility of otherwise inflexible corporations. Thus strategic partnerships serve as a remedy for the problems concerning both SME's and corporations.

The following text focuses especially on the forms of strategic partnerships.

### 5.2 Classification of the enterprises according to their size

#### 5.2.1 Size of an enterprise

Indicators like a number of employees, a turnover of the company, amount of the capital, a profit and so on are instrumental to a classification of the enterprises according to their quantitative aspects. The easiest and the most frequent indicators for the enterprise classification are: the number of employees and the turnover of the enterprise.

There are many classification of the companies based on the number of employees. EUROSTAT tries to create common standard for classification and distinguishes the following categories:

- Micro enterprises up to 9 employees
- Small enterprises with less than 99 employees
- Medium enterprises employing less than 499 employees
- Large enterprises with more than 500 employees.

Another categorization of the enterprises based on the number of employees is used by the Czech Statistical Office. A small enterprise employs less than 20 employees and an enterprise with more than 100 employees is considered to be a large enterprise.

The definition of the small and medium enterprises stipulated by the EU in its recommendation in 2003 is as follows:

1. Small enterprises – organizational units with less than 50 employees and with annual turnover or annual balance sheet total less than 10 million Euros. The company has to

be independent; it means that there is no other subject (company) holding more than 25% of the capital.

2. Medium enterprises – 50-250 employees, annual turnover does not exceed 50 million Euros or annual balance sheet total does not exceed 43 million Euros. As far as independence is concerned, there is the same criterion for the medium enterprises as the one given for the small enterprises.

### **5.2.2 Disadvantages of SME's**

A major disadvantage of SME's is a limited possibility of financing the activities of the enterprise. The most important source of financing is self-financing. It stems from the fact that the resources of SME's are limited. The other disadvantages are as follows:

- Low level of capital assets causes insufficient book depreciation and the company can not afford fluent reinvestment.
- Statistics confirm that small companies are provided with higher interest rates at the bank. It means that the SME's do not invest so much as the large companies do and the ratio "investments/ turnover" in the SME's is also lower. Monetary changes and any financial restriction cause increase of the interest rate and so increase risk.
- Other disadvantages are connected with a manufacturing problem concerning underutilization of production capacities of the machines.
- Insufficient resources to develop new products and to start the technological development.
- The employees in a larger company have higher earnings and more benefits than in SME (training, insurance, food and so on).
- Product quality is the key factor of success of the SME's. Quality is connected with highly qualified employees, who can be replaced only with difficulty.
- Advertising is limited because of financial resources. Prices are very often dictated by the large companies. Marketing is underestimated in SME's.
- Number of top managers is limited, which can cause work overload of other employees. Improvisation and intuition are prevailing.
- The owner of the company is very often a top manager or the director of the company. This fact can be a nuisance, when managing the company.
- SME's must pay attention to avoiding the risks because they can become fatal for SME's.

### **5.2.3 Disadvantages of large companies**

Large companies suffer from difficulties connected with managing of a large organization. The effort to standardize the management practice can lead to the growth of bureaucracy, thus causing inflexibility.

There are problems of the large and SME enterprises given in Table No. 17. They can be solved by forming a strategic partnership, or to be more precise, a strategic alliance.

Table No. 17: Which of the problems mentioned below can be solved by strategic alliances?

	<b>Large company</b>	<b>Medium company</b>	<b>Small company</b>
Management difficulty (level of bureaucracy, problem of intra-organizational control)	3	2	1
Provision of knowledge resources	2	1	2
Organizational flexibility	3	2	1
Professionalism and negotiation power	1	2	2
Innovative behaviour of an organization and its managers	3	2	1
Capital power, disposability of needed resources	1	2	3
Company risks and possibility of their reduction	2	2	3
Efficiency of economic processes	1	2	3
Possibility of quality control in the whole process of the economic activity	1	2	3

1 – it is not a problem, 2- it is already a bit of a problem, 3 – it is a big problem

Source: author

### 5.3 Strategic partnerships

Strategic partnership is a broad notion covering all forms of integration<sup>8</sup> (that is cooperation and concentration) but also other informal agreements. Strategic partnership is a partnership or agreement with another organization for mutual benefit. Partnering organizations are building mutual long-term goals and commitments.

Within this chapter we will mention the following forms of partnerships:

#### 5.3.1 Forms of strategic partnerships

##### 1. „Open“ form of co-operation

- occasional co-operation

Occasional forms of communication and business collaboration involves exchange of the information concerning business condition, opinions about the public sector and other information which is not regarded as being important, meaning that it is not of a tactic or strategic importance.

- „salient“ informal agreements

<sup>8</sup> Forms of integration based on the form of enclosed contract are the partnership deed (silent partnership, consortiums); cooperation (corporation, strategic alliance, price cartel, sales cartel, production cartel, condition cartel, syndicate); concentration (mergers, acquisitions, concern, holding, trust, conglomerate).



These agreements represent the salient agreements concerning prices, manufacturing processes, limitation of mutual competition, exchange of information and so on. They are very often enjoined by national governments and economic competition authorities.

## 2. Strategic alliances

A relationship formed by *two or more organizations* that share (proprietary), participate in joint investments, and develop linked and common processes to *increase the performance of both* companies. Many organizations form strategic alliances to increase the performance of their common supply chain.<sup>9</sup>

Another common definition of a strategic alliance: Strategic Alliance is a partnership between two or more companies to pursue a set of *agreed upon goals* while *remaining independent* organizations. Strategic alliances come in all shapes and sizes, and include a wide range of cooperation, from contractual to equity forms.<sup>10</sup>

Definition according to ASAP (Association of Strategic Alliance Professionals):

- Agreements with „open“ end
- Between separate companies
- Partners are sharing common interests or goals.
  - Informal collaboration with information sharing

This form of cooperation is about experience and information sharing. The partners can share their own market experience, experience concerning other partners and other data resources, experience on market conditions, but also experience about computer programs and so on. This form of cooperation is not legally binding and it is very often based on handshake agreements. The information shared must be interesting for both sides (supplier and subscriber) to preserve mutual cooperation. The **question of trust** can be very problematic, particularly in the Czech Republic.

- Preferred suppliers and buyers

These agreements are very often legally binding and they are connected with the sole position of the partners. This form of cooperation is sometimes called sole agency and is a kind of a long-term cooperation. Example of this form of partnership: long-term obligation to buy or to sell materials and raw materials. This obligation is confirmed by the legal contract or the exclusive position of one of the partner. This partnership form is sometimes based on the **license** with the partner.

Example of the company making use of this form of partnership in the Czech Republic is the company Auto Škoda Mladá Boleslav employing over 300 of preferred suppliers.

Example of the sole agency partnership represents the company **Starlift s.r.o.**, which is the exclusive agent of the American company Caterpillar Lift Truck (manufacturer of material handling equipment for a wide range of industrial and commercial applications). Starlift is a distributor of the lift trucks and it provides the customers of Caterpillar Company with maintenance services as well. The cooperation started 10 years ago. Starlift Company is also the sole distributor for the Slovak market (sole agency).

- Production, assembly, buy back agreement

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<sup>9</sup> Source: <http://www.apics.org/>

<sup>10</sup> Source: Encyclopedia, Wikipedia, [http://en.wikipedia.org/wiki/Strategic\\_alliance](http://en.wikipedia.org/wiki/Strategic_alliance)

The partnering companies are trying to exploit the advantages stemming from the economies of scale. Cooperation is connected with continuous recovery of the capital equipment and later with a buy back by the equipment supplier. The cooperation can involve delivery of more complex machines, starting the operation of the machines, common provision of their maintenance and repair. This kind of cooperation is focused on the improvement of internal processes – it should improve the quality, the quantity and the efficiency of internal processes. It can be the cooperation between a supplier of assembly lines or a service company.

- Management, marketing, service agreement

These agreements concern the collective solution and implementation of external processes. The partners provide common solution and realization of the external processes and they can share distribution networks as well. The external processes can be generally presented by mutually coordinated marketing, assembly and servicing of complicated equipments, common distribution. An example is the company Technicoat cooperating with DuPont (cooperation in the strategic planning of marketing activities).

- Cooperation in R&D

Joint R&D is a strategic alliance whereby two or more organizations agree to combine their technological knowledge to create new innovative products.

- Franchising

It is a method of doing business wherein a franchisor licenses trademarks. Franchising is further understood as tried and proven method of doing business to a franchisee in exchange for a recurring payment, and usually a percentage piece of gross sales or gross profits as well as the annual fees. Various tangibles and intangibles such as national or international advertising, training, and other support services are commonly made available by the entity licensing the 'chain store' or franchise outlet (commonly shortened to one word: franchise), and may indeed be required by the franchisor, which generally requires audited books, and may subject the franchisee or the outlet to periodic and surprise spot checks. Failure of such tests typically involves non-renewal or cancellation of franchise rights.

- Licensing

License agreement enables the buyer to produce and to sell the products and services of the partner. The buyer pays fees for the provided technical production and patent documentation.

Example of a cooperation based on a license is the Czech company **Technicoat s.r.o.**, which operates in the surface coating business specializing in the application of industrial coatings (Teflon, Xylan, Dykor, Halar, Rilsan) and the company Du Pont. Technicoat was awarded DuPont license to apply Teflon® Fluoropolymer coatings „DuPont Licensed Industrial Applicators“. DuPont has not been equipped with the knowledge of the Czech market, so they have chosen the partner, which would be able to serve these markets with DuPont products. Technicoat is also able to supply Slovak and Polish markets. Success of the cooperation is based on the trouble free communication, sharing of know-how, and knowledge of Czech and Slovak markets.

Forms of strategic partnerships like franchising and preferred buyers and suppliers can be safeguarded by a license.

- Outsourcing

The company decides to give other companies some activities which are not core activities of the company. There are many pros and cons of this form of cooperation. The company

outsourcing some peripheral activities can for example save financial resources for provision of core activities. On the other hand, there is a risk of no delivery of the activity.

### 3. **Joint ventures**

JV has its own legal form with its own organizational structure. It can be considered as the broader notion for strategic alliance. It is an agreement between two or more firms that they are going to undertake the same business strategy and plan of action. Two companies want to co-operate (share knowledge, **markets**, and profits) and they decide to create another company together – joint Venture Company. In the Czech Republic this form of partnership is typical for the enterprises with foreign capital. Barum (tyres producer) and the German company Continental created the JV Company Barum Continental together, which has become a part of Continental Group. Both sides of the contract were satisfied. Barum received capital resources to invest in new technologies and equipments and Continental group expanded to the Czech and Slovak markets.

### 4. **„close“ form of co-operation**

The key principle behind buying a company (close form of cooperation) is to create shareholder value, which is higher than the sum of the two companies (the buying one, the one being sold). Two companies together are more valuable than two separate companies – or at least, that is the reasoning behind merger and acquisition.

- **Merger**

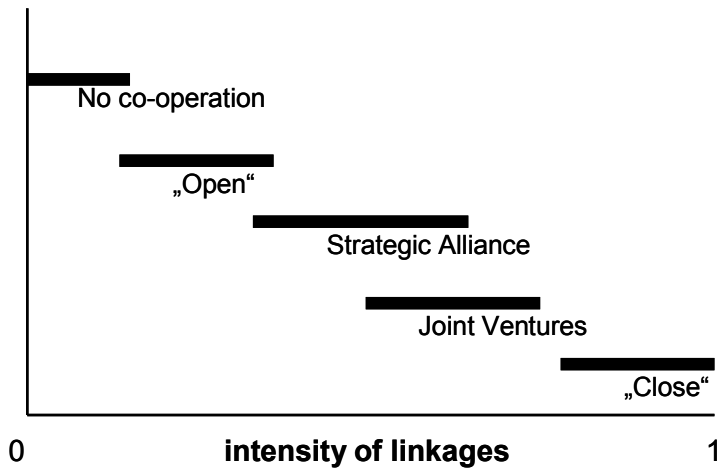
Merger happens when two firms, often about the same size, agree to go forward as a single new company rather than remain separately owned and operated. Both companies' stocks are surrendered and new company stock is issued in its place. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created. In practice, one company will usually buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it is technically an acquisition. Being bought out often carries negative connotations, therefore, by describing the deal as a merger, deal makers and top managers try to make the takeover more palatable.

- **Acquisition**

When one company takes over another and clearly establishes itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded. Acquisition is considered to be more adversarial in comparison with a merger.

The distinction of the forms of partnership is based on the intensity of linkages.

Picture No. 1: Intensity of linkages between the companies



Source: author

## 5.4 Risks of strategic alliances

The company intending to enter the strategic alliance should consider carefully the risks and the motives of entering the partnership. The motives are sharing costs and market risks, combining complementary skills, formulating technical standard and dominant design, accessing new markets and technologies, pre-empting new competitors, reserving learning opportunities.

The problems can arise from the different corporate cultures of the partnering companies. The worst impact of disharmonic corporate cultures will be apparent within companies established by the merger or acquisition.

The partners should undertake the following steps to avoid any complication:

- The partners should discover everything about other alliances, which have been enclosed by the potential partner. Already enclosed alliances of our potential partner could somehow limit the effectiveness of the proposed contract. For example if the potential partner approached a contract which hinders the potential partner to provide any technical or other information.
- The partners should learn about the financial situation of the potential partners.
- If the object of the cooperation is a supply of some product, technology and so on, the company should ascertain everything about the rights of the ownership. Partners should evaluate, if the brand names, trademarks and patents or copyrights will be needed to expand to the international market and eventually launch necessary agreements before entering the partnership.
- The partners should exercise the control over the observance of the agreement regularly to avoid any problems and to reveal any inadequacies.
- Employees are key assets for the companies, because they constitute the knowledge and experience offered to a partner. This is the reason for adding a clause about the prohibition of employing the partner employees to the contract.

Dissatisfactions with alliances followed by their end are as follows:

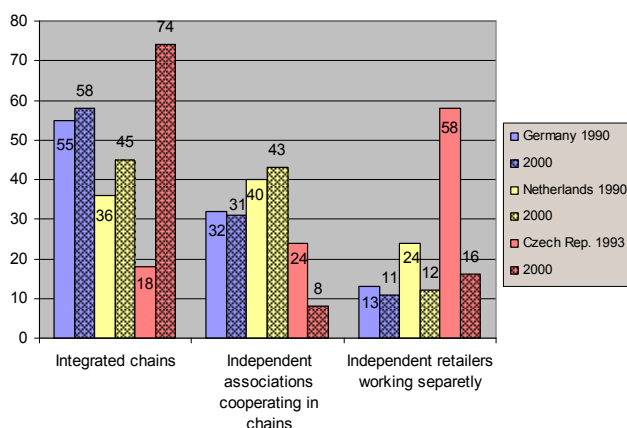
- Low rate of strategies conformity
- Unrealistic expectations concerning the difficulty of establishment and running the alliance
- Key workers do not want to work
- Key workers do not manage to fulfil qualification requirements
- Enemy effort to become independent of the founder

## 5.5 Cooperation in retail and wholesale

Growing number of hypermarkets in the Czech Republic is considered as a threat to small sellers and retailers. Hypermarkets have better purchasing conditions because of the large amount of goods they can purchase and later sell for lower prices. Subsequently they gain customers, which were served by smaller sellers or businessmen. Cooperation in retail and wholesale should provide better purchasing condition for these smaller organizations which are getting bigger thanks to the cooperation.

Tendency toward cooperation is visible in the graph below. We can see rapid decrease in the number of retailers working separately in the Czech Republic between the years 1993 – 2000 (Right side of the graph, decrease from 53% to 16%).

Graph No. 4: Cooperation in retail and wholesale



Source: author

There are four stages of cooperation in retail and wholesale (the level of integration is growing from the first to the last one, the independency is preserved).

### 1. Purchasing and payment alliance

There are 2 types of purchasing alliances: a) purchasing alliance based on central negotiations and b) purchasing alliance based on central negotiations and also central payment. The members of the alliance are direct invoiced by the supplier in the first type of the purchasing alliance. This type is connected with bad payment morality. Thus, the second type of purchasing alliance is better for alliance suppliers, where the central office of the alliance is

invoiced directly and each member of the strategic alliance has its own clearing account by the central office.

## **2. Purchasing and selling alliance**

The alliance members are offering the same assortment, the same design of the outlets, the same business strategy and use of the same retail brands.

## **3. Marketing alliance**

This kind of cooperation involves implementation of the loyalty systems within the member companies. This kind of cooperation demands implementation of joint information systems, which is very often a problem in the Czech Republic.

## **4. Service organization**

This form of cooperation represents the highest level of integration of independent retailers. It is concerned with the services in the sphere of information systems, consultancy, financing, training of employees and so on.

## **5.6 Conclusion**

In this chapter you have read about the forms of strategic partnerships. There are some final remarks stemming from my own experience with the cooperation in the Czech Republic.

- Problem with trust between the Czech companies which are competitors, if they are going to cooperate (the Moravia Silesia Cluster) – it is a problem especially when the cooperation is supported by a public authority
- Foreign partners are mainly trying to produce at low cost in the Czech Republic
- Foreign partners want to expand and do not know the Czech market. That is the reason to cooperate with a Czech partnering company.
- Cooperation between Czech firms in the field of research and development (24 innovative research parks in the CR)
- Expansion of outsourcing

### **5.6.1 Final questions**

1. Try to think of advantages and disadvantages of particular partnership forms and risks connected with them.
2. Which of these cooperation forms are typical for your country?

## 6 CONSUMER'S RIGHTS IN THE CZECH REPUBLIC

Although it might be hard to believe, Czech consumers were protected against unfair practices of producers or sellers even during the socialist era. Majority of the rights that exist now were covered by legislation. The present structure of the supervisory bodies was created at that time as well. Many parts of the special act – Act on Internal Trade – were transferred into the contemporary Act on Consumer Protection. The same we can say about the Civic Code. One of the reasons of the positive situation is that the Czechoslovak Republic was a member of the United Nations Organization, which has contributed to the basic general rules (or rights) of consumer protection. These rules – or the eight consumer rights – as well as consumer protection guidelines are not obligatory, but many countries follow them, to a more or less extent.

Hard times for the Czech (or formerly Czechoslovak) consumers started after the Velvet Revolution in the year 1989. Several years of a kind of anarchy in this area followed, when many entrepreneurs misused the new opportunities in the market not covered by any legislation. Bad work of the courts of justice concerning the extreme length of the legal processes and very high expenditures made the situation even worse. Poor legal acts – for instance the Code of Civil Law or Civil Procedure Code - have caused serious problems to consumers with consequences up till now.

The accession process of the Czech Republic into the European Union, which started in the year 1993, was a significant turning point. Consumer policy and consumer protection form very important part of the EU interests because unsatisfied consumers present quite a great barrier for the free movement of goods or/and services. In addition, consumers' claims on defected goods amount to the productivity fall and increase of the company's costs, which might lead to the whole EU's uncompetitiveness.

The Czech government had to accomplish many tasks before the entry into the EU to ensure comparable conditions for Czech consumers. Two basic conditions had to be met:

- legislation “reconstruction” and formation ensuring consumer rights as well as obligations and on the other hand, obligations for the entrepreneurs in the area of consumer rights and
- organisations structure – i.e. all the spheres of the consumer policy have to be given in charge of the bodies with the clear tasks, responsibilities and “rules of the game”.

Today we can claim that the situation of the Czech consumer is on the same level as that of any citizen of any member state in the EU.<sup>11</sup> In reality, however, this statement has many different levels. There are still some problems with consumer protection – mostly in the new EU countries – to be solved. Parallel to that, the EU consumer policy develops all the time and new tasks must be implemented into practice.

The EU countries have to work out, realize and monitor formal programme documents concerning the strategies and plans in the area of consumer interests, called – as it was mentioned above – “consumer policy”. These documents should correspond with the EU consumer policy programme prepared by the Directorate General for Health and Consumer Affairs (or DG SANCO) reflecting specifically the tasks coming from every country's situation in the sphere of consumer protection.

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<sup>11</sup> Although there is a common level of protection in the whole European Union, in fact there are quite great differences between the North and South and the West and East based on their history and culture.

The first Czech formal consumer policy was formulated and implemented in the years 1999-2000. One of the main goals of this document was to create a base for the consumer organizations activities. At the beginning of the 2006 the new third programme of consumer policy has been prepared, which should be followed until the year 2010. All national consumer policies stem from the European one, but they are modified to suit the actual needs in every country.

This programme gives us a clear picture of the present situation concerning the consumer protection in the Czech Republic, the main directions of future development as well as the institutional framework.

Who are the “stakeholders” of the consumer policy? There are several groups with different interests and positions, functions and level of involvement: the government, supervisory bodies, consumer organisations, consumers themselves as well as independent organizations and entrepreneurs. We will pay special attention only to the first three subjects; some others are mentioned in the Consumer Policy 2006-2010 programme, which is dealt with further in the text.

Czech government – creates legislation, formulates consumer policy, establishes and manages special organisations, e.g. supervisory bodies in the sphere of the consumer policy, supports (also financially) projects and programmes concerning the goals of consumer policy (e.g. education). There is a special governmental body – the Sectoral Consumer Protection Group within the Ministerial Coordination Group, which is responsible for coordination and provision of relevant activities. The Ministry of Industry and Trade represents the umbrella organisation with the most responsibilities.

Other competent central state administration authorities (especially the Ministry of Health, the Ministry of Agriculture, the Ministry of Finance, the Ministry of the Environment, the Ministry of Regional Development, the Ministry of Justice, the Ministry of Informatics, the Ministry of Transport and the Ministry of Education, Youth and Sports) provide information concerning consumer protection issues, including information required to safeguard cooperation in the implementation of common approaches.

Some of the Ministries have founded supervisory bodies, which take care of the observation of the rules on the market. The others are “less active”. They prepare legislation proposals, makes surveys or ensure the needed information for consumer policy implementation. The Ministry of Industry and Trade is also responsible to some extent for the existence of the ECC Prague (European Consumer Centre) founded on 1st January 2005 within the financial support of the European Union, which offers free of charge information and advice on consumer rights in the EU. It also offers free of charge cooperation and assistance to consumers when setting their complaints as to quality of products and services being bought, complaints concerning behaviour of entrepreneurs in other EU Member States, as well as in Norway and Island. It further works as a contact point for the free of charge assistance to consumers at out-of-court settlements of their disputes in the same region.

Let us introduce some of the supervisory bodies:

Czech Business Inspectorate (Ministry of Industry and Trade)

The supervisory authority over the introduction to the market and sales of non—foods products and services — product safety, product technical requirements, fairness of sales, provision of fair and accurate information about products and services, prohibition of



misleading of and discriminating against consumers, and the quality of petrol, consumer loans and tourism services, etc. This body works under these acts:

Czech Trade Inspection Act, No. 64/1986 Coll., as amended

Consumer Protection Act, No. 634/1992 Coll., as amended

Act on Technical Requirements of Products, No. 22/1997 Coll., as amended

Act on General Product Safety, Act No. 102/2001 Coll., as amended

Act on the Liability for Damage Caused by a Defective Product, No. 59/1998 Coll.

Act on Some Conditions for Concluding a Consumer Loan, No. 321/2001 Coll.

Civil Code Act. No. 40/1964 Coll., as amended

Commercial Code, Act No. 513/1990 Coll., as amended.

#### Czech Agricultural and Food Inspection Authority (Ministry of Agriculture)

The CAFIA inspects foodstuffs, ingredients for their production, agricultural products except for meat and meat products, fish and eggs, soaps and detergents, and tobacco products. This competence applies to production, warehousing, transport, and sales (including imports). Its work concerns monitoring and protection of economic interests of both consumers and the state – consumer protection from foodstuffs that are risky to human health, falsely labelled, sold despite their expired use-by-date or of unknown origin. The manufacturing and sales conditions form an integral part of the target inspection. The term food safety means the control of microbiological requirements and contents of contaminants (e.g. chemical substances, additives, pesticide residua, etc.). The term quality control means the control of analytical characteristic features (e.g. the contents of fat and sugar, humidity, etc.), or the control of sensory characteristic features. Product labelling and its adequacy are assessed separately.

The legislative ground for the CAFIA activities is formed by:

Act on Foodstuffs and Tobacco Products No. 110/1997, Coll., as amended

Act on CAFIA No. 146/2002 Coll, as amended

Act on State Control No. 552/91 Coll, as amended

as well as by a great range of governmental orders or ministerial decrees.

#### State Veterinary Administration (Ministry of Agriculture)

The main tasks of this authority are the protection of consumers from products of animal origin likely to be harmful to human health, monitoring of animal health situation and maintaining it favourable, veterinary protection of the state territory of the Czech Republic and the care for animal welfare and animal protection. SVS works under the Veterinary Act No. 166/1999 Coll, as amended and many governmental orders and ministerial decrees.

Food Safety Information Centre - The Institute for Agricultural and Food—Related Information (ÚZPI) (Ministry of Agriculture)

- performs the role of a food safety information centre. The ÚZPI created and operates the "Food Safety" information portal, through which it informs specialists, as well as consumers

at large, about food safety issues in the broadest context (from the safety of food ingredients, to food production, and to the way it is served on a consumer's table).

#### Regional Public Health Authorities (Ministry of Health)

Public health protection authorities check that products intended for daily use are not harmful to health — products for children less than three years of age, products which come into contact with foodstuffs, toys, cosmetics, and public dining. Other areas of interests are the quality of drinking water, air or environment, healthy living and working conditions and the protection against epidemic diseases.

The basic legal acts important for the activities of these authorities are:

Act No. 258/2000 Coll., on the Protection of Public Health

Act No. 320/2002 Coll., as an authority for the protection of public health

#### State Institute for Drug Control (Ministry of Health)

The Institute performs state supervision with respect to the qualities of human medications in all the areas they are used in. With respect to health resources, the Institute performs checks with health care providers, investigates undesirable incidents, and checks clinical assessments.

#### Assay Office (Ministry of Industry and Trade)

The Assay Office, as a state authority, carries out state administration in the field of assay marks (hallmarking) and precious metal testing. Above all, it conducts on-site assay inspections of the producers and retailers of products made of precious metals, imposes sanctions for any shortcomings ascertained, and verifies or otherwise ascertains the fineness of products or other items made of precious metals, etc. On its web pages the office informs public about the false hallmarks on the Czech market.

#### Czech Authority for Weapon and Ammunition Testing

Carries out testing and expert tasks concerning firearms, ammunition, pyrotechnical products, explosives, propellants, and protective means resistant to bullets, shell fragments, and knives.

#### Czech Metrology Institute

Ensures the uniformity and precision of measures and measuring in all fields of scientific, technical, and economic activity. The Institute provides services in three categories of metrology, namely in legal metrology, fundamental metrology and dissemination of units – calibration.

The basic legal acts are:

Law No. 505/1990 Coll., on Metrology, as amended

Law No. 20/1993 Coll., on State Administration Discharge in the field of Technical standardization, Metrology and Testing

Law No. 22/1997 Coll., on Technical Requirements for Products, as amended

There are also several consumers' organizations, which play the advisory role aiming at the consumers. Some of them also help with the supervision of the market. The most active – which are given here – are also the members of the leading international consumers' associations.

Consumers Defence Association — SOS

- provides consumer consultation, publishes the magazine "Shield of Consumer", publishes leaflets, brochures and CD-ROMs to help with the education of Czech consumers, monitors food safety etc.

Civil Consumer Association

- offers the same advice and services as the previous one, but is more active in testing the products. It publishes the magazine TEST.

Civil Consumer Association TEST

## 6.1 The Consumer Policy Programme for 2006-2010

The basic objectives of consumer policy in 2006-2010 include the protection of consumers from risks and threats that they are unable to influence themselves (especially the safety of products and services, consumer aspects related to the use of new technology, including electronic trading and sales via mobile phone, and the ethical behaviour of entrepreneurs), consumers' ability to make better-informed decisions on their interests, consideration for consumer interests in other policies, including the preparation of legislation with consumer-related impacts, and active participation in the events within the European Union and other international organizations.

The 2006-2010 consumer policy programme also strives to safeguard the basic rights of consumers, such as the right to:

- a) the protection of health and safety
- b) the protection of economic interests
- c) compensation
- d) information and education
- e) representation in the handling of claims
- f) form consumer protection associations
- g) relevant choice in relation to the environmental and social impacts of consumption.

To meet the general objectives of consumer policy for the upcoming period, some elementary priorities need to be set. These priorities have been identified as follows:

- a. increased awareness in the field of consumer protection, the development of proactive information and educational activities to the benefit of consumers.

There will be a particular focus on price comparison systems, indications of consumer attitudes and satisfaction, the reinforcement of product and service safety, a restriction of their

negative environmental impact, the protection of consumers' warranted interests in the use of telecommunication services, energy procurement, transport service provision, etc.

Consumer organizations will be able to have a say in the development of the knowledge base through their own research and evaluations of consumer enquiries and complaints, and will be able to use the information base that has been built up.

b. the greater efficiency of regulation

Besides the protection of consumer health and safety, the protection of consumers' economic interests also needs to be strengthened in the form of legislative amendments and through the provision of information about rights and methods of exercising these rights. An important step in this area in the upcoming period will be the transposition of the Directive (EC) 2005/29/EC concerning unfair commercial practices and measures to ensure the corresponding standard in the effective enforcement of the law. In connection with this new legislation and the recodification of the Civil Code, it would be expedient to review the current Consumer Protection Act and adapt it to the new conditions.

At the same time, it is advisable to support the creation of codes of ethics connected with the manufacture and sale of products and the provision of services. Consumer protection from incorrect measurements in commercial and administrative transactions is one of the fundamental roles of legal metrology, focusing on measuring devices subject to inspection under the law. The problems that need to be tackled in the immediate future concern the roles of legal metrology in an area harmonized with the European Union and, on the other hand, in an area that has not been harmonized and is subject to national law, where the aim is to achieve the highest possible level of compatibility between systems. It is also necessary to find an optimal solution for measuring devices that are not subject to Act No 505/1990 on metrology, as amended, and which, given their significance, are subject to ministerial regulations (e.g. in the fields of transport, food and health). As new digital technologies are developed, the need to protect consumers in relation to the use of these technologies has also surfaced. As regards European legislation, active participation is required in the preparation of new legal regulations (both in the field of consumer protection and in fields with a consumer impact, such as the Services Directive) and in the review of the consumer acquis that is being prepared.

c. the support of self-regulation, dialogue between state institutions and consumers, and dialogue between enterprises and consumers

The main areas here are:

- intensification of dialogue between consumers and state institutions, mainly by fostering conditions for consumers, or their representatives, to take part in discussions of matters that affect consumers; the opportunity to put forward comments in the legislative process, involvement in various working parties on specific areas, such as the creation of standards etc.
- the promotion and capacity-building of consumer organizations, reinforcement of consumer organizations and their capacities in areas and regions,

d) the increased effectiveness of market oversight

The effectiveness of market supervision needs to be enhanced in the following areas:

- the safety of products and services on the market, including involvement in warning information systems on the occurrence of dangerous products on the Community's internal market,
- the protection of consumers' economic interests,
- financial and travel services,
  - e-commerce,
  - reactions and searches for appropriate instruments to handle damage to consumers in the light of new problems, such as sales over mobile telephone, the limited possibility of using new technology,
  - effective cooperation among market oversight bodies within the Community's common internal market,
  - the education of persons responsible for enforcing the law,
  - the creation of a user-friendly interconnected system of information run by supervisory bodies and accessible to the general consumer public.

Consistent with the Regulation (EC) No 2006/2004 of the European Parliament and of the Council on cooperation between national authorities responsible for the enforcement of consumer protection laws, from the end of 2006 new control procedures will be applied in cross-border cooperation between the oversight bodies of individual Member States.

e) support for the development of out-of-court settlements to consumer disputes

In the case of consumer dispute mediation, there will be an improvement in the activities in place today, carried out primarily by nongovernmental consumer organizations in the scope of their projects and supported by state authorities. The Ministry of Industry and Trade will continue to provide financial grants for these projects. At the same time, it will be expedient to raise awareness among the consumer public of the possibility of applying this means of resolving disputes.

As regards arbitration for consumer disputes, it will be necessary to assess existing legislation and the suitability or possibility of using this legislation for all consumer disputes, with consideration for certain specific features (the conclusion of contracts by implication, liability for defects, etc.); it will subsequently be essential to propose legislation that will safeguard easy consumer access to this form of extra-judicial settlement.

f) support for activities connected with the sustainable development of consumption

Communication with citizens needs to be reinforced and improved in order to provide them with the necessary information important for the protection of their consumer interests, especially for qualified decisions on the goods or services they purchase. Support will be provided for the projects of nongovernmental consumer organizations focusing on intensifying the information provided to consumers on the technical, safety and health parameters of selected types of products throughout the chain: manufacturer, distributor, seller, consumer. Communication needs to be developed at the level of state administration authorities, supervisory bodies and consumer organizations. It is also important for consumers

to be informed of the results of market inspections, e.g. as regards prices, cross-border purchases and the related handling of disputes, fraud, accidents and injury.

Sustainable consumption programmes place suitable pressure on the conduct of the parties concerned (the producer, the retail chain, institutions and enterprises as consumers, individual consumers, and the media). Programmes to promote sales of environmentally friendly products (e.g. Government Resolution 720/2000), green public procurement in general, sales of fair-trade products, the selection of 'green power', and healthy and local organic foods, are good, proven instruments that need to be reinforced in the Czech Republic.

In connection with the task of educating consumers, an emphasis should be placed on the following activities:

- the issue of publications (general and specifically specializing in selected themes of consumer protection)
- regular Internet updates, including the creation of a section on 'consumers' frequently asked questions'
- an evaluation of, and any necessary adjustments to, the curricula of primary and secondary schools as regards the teaching of consumer affairs, including matters related to sustainable consumption
- training in the field of consumer rights for consumers and business entities
- media coverage of consumer rights
- in cooperation with the Ministry of Education, Youth and Sports, greater awareness of the range of products on sale ('merchandise education') will be initiated.

g) support for activities and development of consumer organizations

The main aims of support will be integration and improvements in the consulting and information services provided to consumers, involvement in educational and awareness activities, the implementation of collective cases protecting consumer interests, increases in the membership and sponsors of consumer organizations, improvements in the ability of consumer organizations to help consumers, the monitoring of unfair trading, consumer warnings, and representation of the interests of consumers at national and international level.

From the long-term aspect, it is necessary to support the ability of consumer organizations to generate their own resources, whether from the provision of services to consumers, subscription fees, etc., or in connection with legislative amendments currently being considered (tax assignment, the bringing of collective actions for compensation, etc.).

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## 7 THE CZECH NATIONAL QUALITY PROGRAM

According to The European Quality Charter, the quality is at the top of decisive the factors of competitiveness of enterprises as well as countries in the global world economy. Although the entrepreneurs can be considered to have the most important role and responsibility for quality and business excellence, even in advanced market economies they are not left without some kind of the governmental support.

National Quality Programs (or policies) came into being on incentive of governments in more than 80 countries in the world. Some are based on promotion and support of quality system certification according to the ISO 9000 management quality system standards, others on the support of total quality management programs with national quality awards. The Czech National Quality Policy is a combination of the above-mentioned approaches. But in nearly every country, where some form of national government interest for quality exists, November is “celebrated” as the month of quality and the second Thursday in November as the “World Quality Day”.

With a little exaggeration we can say that the Czech (or Czechoslovak) economy missed the start of a new quality era, which has begun in the 1980s and is mainly connected with the Total Quality Management Concept or Business Excellence Quality Awards. On the other hand, the speed of acceptance of quality importance in the Czech society during the last years (especially at the beginning of the 21<sup>st</sup> century) is really remarkable and comparable to the quality perception in the most advanced countries. This statement is possible mostly thanks to the self-interest of the Czech entrepreneurs, raised by the need to be competitive not only at the internal market, but also abroad, and the effort of the Czech government.

It may be interesting that the first official government support of the National Quality Policy is connected with the membership of the Czech Republic in the NATO, which was followed by the entry into the European Union. Many Czech enterprises appeared to be potential suppliers to the NATO army (or were suppliers of the Czech army at that time) and started the process required for obtaining the AQAP (Allied Quality Assurance Publications) certificate of quality according to the NATO standards.

According to the requirements of NATO, each member state has to have its own system of state quality assurance (GQA – Government Quality Assurance), determining the standards for suppliers in the case of deliveries into other states or in the case of common army programs. The basic procedures concerning GQA are stated in the document STANAG 4107. Mutual acceptance of government quality assurance and usage of allied quality assurance publications was ratified in December 1999 and fully implemented in January 2002.

In the Czech Republic, the sector of state quality testing for the army supplies is in the competence of the Main Authority for Standardisation, Cataloguing and State Quality Verification of the Ministry of Defence (MASCSQV MD).

In the frame of the accession process of the Czech Republic into the European Union, the European Commission recommends to declare the National Quality Policy to be an integral part of the affiliation program of the Central and Eastern European countries.

The first working meetings and consultations with a EU’s expert took place in March 1998. This visit resulted not only in a report for the EU about the situation in this field in the Czech Republic, but also led to the concept of the "National Quality Policy", project elaborated in co-operation with the Czech Society for Quality – we will pay attention to this organisation later in the text.



The final form of the National Quality Policy Program was elaborated as the governmental declaration and special decree two years later.

According to this “Decree of the Czech Republic government No. 458 of 10<sup>th</sup> May 2000 about the Czech Republic National Quality Policy” there are some responsibilities of the chosen subjects in the main areas of national quality policy. For instance:

- the vice-president of the government, the Finance Minister and the Minister of Industry and Trade are charged by the government of the Czech Republic to update the National Policy continuously according to developments in the EU;
- since the year 2001 ministers are in charge of working out projects for the support of quality always till October 31<sup>st</sup> of the preceding calendar year;
- the Czech Society for Quality is commissioned by the Minister of Industry and Trade to act as secretariat and as National Policy Information Centre.

The main and general goals of the National Quality Policy are:

- to strengthen the competitiveness of the Czech economy and its subjects in the European and world markets
- to support the economic growth
- to help to protect the environment and natural resources
- to upgrade the quality of work and services in the public sector (including state bodies and organizations)
- to help to build the image of Czech quality and to influence the changes in the citizens' perception and attitudes to the Czech products
- to support the quality of work and services in the public sector, state administration, public transport, power industry, health service, school system, police, banking, insurance and others.

The Quality Council of the Czech Republic as the advisory coordinating and managing governmental body had been established and is affiliated to the Ministry of Industry and Trade. The council supports the management and application of all methods and instruments, which help to promote quality in all areas of the Czech society's life. The coordination of state institutions' activities means better relations between branches of the State administration and their policies (e.g. industrial policy, environmental, social policy, regional policy, structural funds etc.). This area also includes quality education in schools, promotion in mass media, publishing of promotional and professional publications, support of citizens' associations and initiatives acting in the quality field, education and improving consumers' knowledge.

Council members are representatives of all branches of the State Administration, of entrepreneurs' associations and of non-profit nongovernmental organisations dealing with quality. The National Information Centre for Quality Promotion acts as the Council Secretariat. The Centre administrates – among others – several databases containing for example the documents of the National Quality Policy, the certification and inspection bodies, National register of the certificated organizations, of the magazines published by the Centre, Press news etc.

The Decree is quite simple in its contents because the heart of the matter is the material worked out every year (with the same heading plus the current year) and full of various (about 200) activities from different areas concerning quality. These activities are ensured by several

dozens of organisations – nongovernmental and non-profit as well as profit-aimed enterprises – in the areas of education and training, consultancy, accreditation, certification, standardization, metrology and testing, environmental care, health and safety at work and consumer protection, banking, mass media. In some cases the actions are planned for every month or even week. Regarding, for example, mass media (especially those operating under public law), their role is mostly to popularise National Quality Policy principles among the general public. They publish for instance examples of successes of the leading organisations concerning the quality issues.

Let us present some examples from the material for the year 2006:

- 15<sup>th</sup> annual international conference “Quality 2006”
- “The Excellent Product of the Year 2006” – competition organised by the Design Centre of the Czech Republic (governmental organisation)
- National Quality Award 2006
- “Czech Quality” Award Programme
- “Manager Excellence” training course
- “Software for Quality Management” training course
- Controlled Quality in Health and Social Care Sphere Congress
- seminar ISO 22000:2005 on food safety
- publication: “Good Manufacturing and Hygienic Practice – HACCP – Manual for Boarding Services”
- publication: “Handbook for Workers Responsible for Conformity Assessment of the Construction Products”.

Beside the above-mentioned goals we can divide the main tasks of the National Quality Policy into the following three areas of interest:

- a. protection of public interests<sup>12</sup> – to optimise legislation and associated activities including the work of inspection and surveillance bodies;
- b. support of entrepreneurs/companies - to create conditions for the development and support of all activities aimed at business success, improvement of domestic product quality, improvement of the position of Czech products on world markets and increasing the citizens’ trust in domestic producers (service providers) and their products;

Concerning this point there is also an area for the indirect influencing, which includes e.g. support of projects of nation-wide importance, support of entrepreneurial subjects in implementing permanent quality management improvement programs (systems of quality and environmental management according to standards ISO 9000, ISO 14000, integrated

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<sup>12</sup> Under public interest we understand, for purposes of this paper, safety of products, production processes and services with respect to health, protection of persons and property from being endangered by defective or dangerous products and processes, safety of building structures, environmental protection, customer protection and assurance of high quality of means financed from public sources. This also includes protection against undesirable activities of entrepreneurial subjects and surveillance and inspection activities.

management (ISO 9000 + 140000 + safety and health protection at work – British standard BS 6079-1996), HACCP (Hazard Analysis Critical Control Point<sup>13</sup>), EMAS (Environmental Management Assurance System), implementation of the European TQM model leading to Business Excellence<sup>14</sup>, the program of the Czech Republic National Quality Award (see further in the text), product and service quality verification and labelling systems, verification and labelling of environmentally friendly products, European Quality Award for small and medium enterprises etc.

The certification of quality systems according to ČSN EN ISO 9000 standards found understanding in the entrepreneurial sphere in the Czech Republic; about 8000 organisations as well as enterprises have been certified up to now (year 2006). As a point of interest, the number of ISO certificate holders in this country has risen fivefold over the past seven years. The certification is a partial advantage and/or a necessity while gaining public and private orders. Apart from ISO 9000, there is a growing interest in ISO 14000 certification (Environmental Quality Management).

ISO certification can also be financed through the European Union's Phare 2003 – Technology Program. So far, Czech enterprises have drawn about 18 million euros (540 million CZK) from the program, which is arranged by the state agency CzechInvest. Money from this program can be used for implementation of new technologies, acquiring know-how, or for getting ISO certificates. Up to the year 2006 Czech enterprises have drawn money for 85 such projects.

Another example is from the public – private – partnership sphere. In the year 2006 CSOB (Česká obchodní banka – the Czech Commerce Bank) in cooperation with The **Economic Chamber of the Czech Republic** has launched special loan programme to support and help small firms employing less than 39 people with obtaining ISO certification.

When we discuss the promotion of domestic products quality, there are several points to be mentioned:

- 1) marketing promotion of Czech food products – The National Quality Mark KLASA (in the frame of the Czech National Domestic Food Promotion Programme), which is awarded for three years since the year 2003; and the quality is regularly assessed and monitored by the Czech Agriculture and Food Inspection Authority;
- 2) Programme “the Czech Quality” (since the year 2002) which aim is to create a unified system of credible marks objectively assessed by the independent organisation (accredited testing laboratories). Holders of the mark can use the logo “Czech Quality” on their products. Up to the year 2006 there are about 2500 products (along with services) on the Czech market – e.g. footwear, furniture, gas equipment along with marks for chosen products of the retail chain TESCO or the chain Metro.
- 3) the support of the mark “Ecologically Saving Product” (EŠV – “ekologicky šetrný výrobek”).
- 4) Czech Republic National Quality Award (examples of the award holders are: T-Mobile Czech Republic a.s., Eurest, a.s., Gity holding, IBM Czech Republic, Třinecké železářny, a.s.)

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<sup>13</sup> see the Act No. 110/1997 Sb., on food and tobacco products

<sup>14</sup> EFQM (European Foundation of Quality Management) Business Excellence

- c) others: - to support continuous development of standardisation, metrology and testing primarily in relation to the protection of public interests; to ensure the development of public service quality (health care, transport etc.); to support the quality of the environment; to support upbringing and education at schools, lifelong education, employee re-qualification according to market needs as well as employee education, training and re-qualification as well as to ensure the state quality verification system managed and coordinated by the Ministry of Defence in connection with NATO defence structures.

National Quality Policy Program contains also actions for motivation of entrepreneurial subjects - especially attitudes of top managers - to implement programs for permanent improvement of management and product quality.

Another task is to create a unified system of quality assurance of public orders and to support the use of the CAF (Common Assessment Frame) in public sector for the quality management self assessment and organizational improvement.

Except for the above-mentioned authority - Quality Council of the Czech Republic – there is another important subject bringing quality issues into practice - Czech Society for Quality (CSQ or ČSJ). The CSQ was the first nongovernmental body established in the year 1989 to promote the importance of quality and it is not a mistake to say that its position in the National Quality Policy is irreplaceable.

There is not enough space to introduce all activities of this organisation, therefore we mention just some of them. For instance, CSQ cooperates very closely with the Association for the Czech Republic Quality Award to realise the program of the Czech Republic National Quality Award. Presently CSQ participates in the European Quality Award program for small and medium enterprises, which started at the end of 1996 and offers entirely non-discriminative access to Czech organisations.

The Czech Society for Quality is also a member of the Czech Association of Management Education and Training Institutes Network. In 1995 CSQ has obtained, as the only organization in the Czech Republic, an Accreditation Certificate of the European Organization for Quality and it is accredited to certify workers active in the area of quality assurance of production enterprises, laboratories and organisations of the administration in several areas:

- Quality Manager
- HACCP Manager
- Metrology Manager
- Environmental Management System Manager
- Quality Professional
- Quality Technician
- TQM Leader
- VDA Auditor etc.

CSQ Consulting Centre also offers consultations in the following areas, e.g.:

- development of quality systems according to standards of the family ČSN EN ISO 9000 in production and services;

- implementation of quality systems according to requirements of VDA, QS 9000, HACCP and APQP;
- optimisation of costs of processes and systems;
- measuring and improving productivity;
- implementation of statistical quality control methods and for solving specific problems of application of statistical methods;
- the application of FORD's methods of process improvement.

CSQ cooperates with the world leading organisations in quality matters: European Foundation for Quality Management, European Organization for Quality, Global Benchmarking Network, American Society for Quality and Institute of Quality Assurance.

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## 8 CZECH RETAIL AND ITS DEVELOPMENT

### 8.1 Retail development

Retail in the Czech Republic, as well as in majority of the Central and Eastern European (CEE) states has been developing incredibly dynamically since 1989. During one decade the market with a continually sub marginal offer with explicit supplier's dominance has been transformed into the market with prevalence of offer, predominance of business firms and increasing customer's influence.

Mainly multinational supply companies established new, more efficient and modern distribution channels. They were the initiators of this sweeping transformation. While in 1990 there were 0.3 m<sup>2</sup> of retail floor space per inhabitant, the number in 1999 increased up to 0.9 m<sup>2</sup> (Czech Statistics Office: Retail census). In the sphere of quick turnover goods, the market proportion of hypermarkets, supermarkets and discount stores is comparable to the Western European countries.

In this context it is necessary to highlight that business concentration and internationalization as well as their growth had a key impact not only on the entire branch, but they influenced the whole country's economy as well. The pressure that retailers put on the suppliers was indirectly spread into the entire business sphere, which finally resulted in productivity increase and general competitiveness of many companies.

### 8.2 Retail & Hypermarkets

According to Z. Skála from Incoma Research company (Skála, 2006), the Czech retail market went through 3 phases of change. The first one lasted from the privatization of state-owned shops until the mid 1990s and represented the coming of new companies to the market and retreating of independent trade simultaneously. Except for the company Lidl, all of the current biggest actors came to the Czech Republic during these years. Discount type of shops developed in those times above all. The level of competitiveness was moderate.

The second phase started with the expansion of hypermarkets. The first hypermarket was opened in the Czech Republic only in 1997 and their number increased to more than 100 in five years. The vast majority appeared within the period between 1999 and 2001. No European country has experienced as rapid boom in hypermarkets as the Czech Republic.

Nevertheless, even this short period was long enough for hypermarkets to become the most preferred retail format for Czech customers. At the beginning of the 90s most Czech households did their grocery shopping in smaller self-service stores. Then supermarkets took over the leading role, but not for a long time. At the end of 2001, hypermarkets have overtaken the lead – they were preferred by 29% of Czech households.

The third phase began with the new decade and continues up to date. Hypermarkets gained control over one third of the market of quick turnover goods. However, their expansion was not on account of independent shop keepers and cooperatives anymore. It was the supermarkets and smaller self-service stores that lost some customers (decline to 26% and 20% respectively), while discount stores (oriented mainly to price sensitive shoppers) have kept on increasing slightly – they are preferred by 18% of households.

The increase of hypermarkets' share has stopped. Large retail chains in the process of increasing their market position escalated the competition by building more new outlets. In some cities the supply has already outgrown the real consumer spending potential of its area

(e.g. Opava, Karlovy Vary, Hradec Králové), which negatively affected the stores' turnover results. The probability that some of the newly built shops will have to be closed down due to their bad economic results is growing. Julius Meinl and Edeka are examples of that. The French retail chain Carrefour had to sell all its outlets and has left the Czech market. They were probably not the last ones (Regál, 2005).

That is also a proof of the market consolidation. The share of the top-five retailers in the Czech Republic is 45%, which is significantly less compared to the majority of Western European countries (e.g., in Austria the share of the top-five retailers is 73%) (PwC, 2006). This shows the potential future evolution of the market.

What was the reason for such extreme hypermarket boom after the year 2000? Hypermarkets have rated higher than most other types of stores in most key parameters such as price, product range and offer quality. The popularity of large retail centres and hypermarkets stems from the fact that most Czech household enjoy the possibility of doing their entire shopping "under one roof". It also goes along with the Czech consumer's increased mobility: three-fifths of Czech households have become accustomed to regular use of their car when shopping.

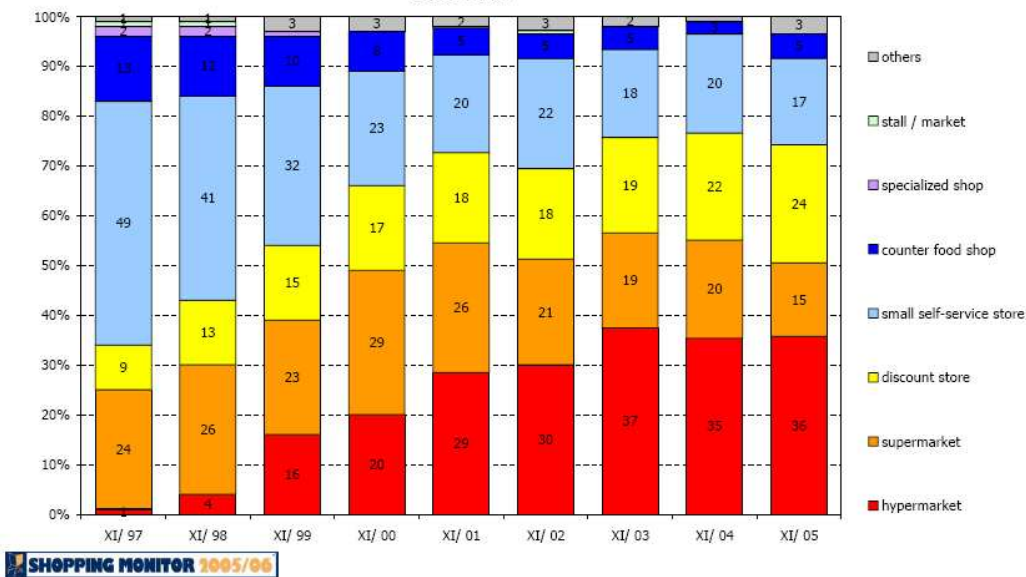
Today's retail market does much more than offer goods for a price – it also offers a kind of shopping experience. Increasing numbers of customers consider the value of their time as well as the price of goods when shopping. They want to spend the time pleasantly and efficiently.

Data also show that Czech customers are more and more demanding. Their satisfaction with shopping conditions is relatively high, however, in the last year we can observe a growing criticism. Besides the traditionally important factor of price, goods quality, product range or store accessibility, speed of service or availability of parking facilities are of growing importance.

The customers' claims had its impact on the discussions about the opening hours of shops. Pressure from labour unions and certain political parties led to proposal of the law limiting opening hours (generally speaking from 6:00am to 10:00pm). The law was not accepted in the end. Opinion polls carried out in the Czech Republic have shown that Czech consumers as well as small entrepreneurs are against any restriction of opening hours in large stores (GfK, 2005).

Graph No. 5

THE MAIN SHOPPING PLACE FOR FOOD ACCORDING TO THE TYPE OF STORE - DEVELOPMENT  
1997-2005



Source: Incoma Research and GfK Praha

### 8.3 Latest facts about Czech retail

Preferences of hypermarkets got stable and they are still the preferred shopping places for 36% of Czech shoppers. However they reached their top market share in 2003. 6 new large shopping centres and 31 hypermarkets grew up in the Czech Republic in 2005, which is more than ever in its history. By the 1<sup>st</sup> of January 2006 there were already 192 hypermarkets operating in the Czech Republic. In 2005 most new hypermarkets were opened by the Kaufland company and there is even more rapid expansion of Tesco, which is strengthening its position in smaller cities.

Twenty-four percent of households mention discount shops as their preferred places of shopping. The main attractions of discount shops are the low price levels, the proximity of these shops, goods on sales, the easy access by cars, and the satisfactory capacities of the parking lots. The strengthening of the discount shops' position is happening to the detriment of supermarkets as preferred shopping places. Their popularity declined in the Czech Republic from 20% down to 15%. This kind of shops is currently preferred by fewer customers than small self-service shops and shops selling over the counter. These more traditional shops still remain the main shopping places for 22% of customers (GfK, 20005).

Shopping via the Internet is advancing as well – according to the research of Faktum Invenio, 16% of Czechs aged 15 years and older have personal experience with purchasing via the Internet. However, only 4% used the Internet to purchase consumer product more than five times. A few years ago, a typical Internet customer was a university educated young male. Nowadays the customer base includes a much wider age spectrum of Internet customers and an increasing percentage of e-shopping women. The most often purchased items are electronics, books, CDs, DVDs, clothes and air-tickets (Faktum Invenio, 2006).



According to different qualitative criteria, Globus has got the best assessment result in the three monitored categories (the assortment spectrum on the offer / the freshness and quality of goods / general atmosphere and the shop environment). The leading position, from the price level point of view, has been retained by Kaufland (GfK, 2005).

Concerning the trends, there is a distinct shift of modern shopping complexes to the proximity of city centres. The Tesco's strategy can be example of this. Another apparent trend is the growth of an average size of shopping centres.

In spite of the growing popularity of large centres, there will also be space for smaller stores on the market. Small stores must accurately profile their orientation according to the local market situation, define their target group and pay more attention to their customers – impersonal hypermarkets can hardly compete with smaller stores in this respect.

Alternative Trade Channels (independent convenience stores; stalls in shopping centres, shops in gas stations, railway stations or in multiplexes) have chances to succeed. PriceWaterhouse Coopers expects more than 50% of food to be traded here - outside classical retail. This will be a response to population aging, singles, incomplete families, and lack of free time. For traditional multi-member families the Alternative Trade Channels will be the next place to shop after hypermarkets, in which they do their weekly shopping.

#### **8.4 Central and Eastern European shoppers – are they similar?**

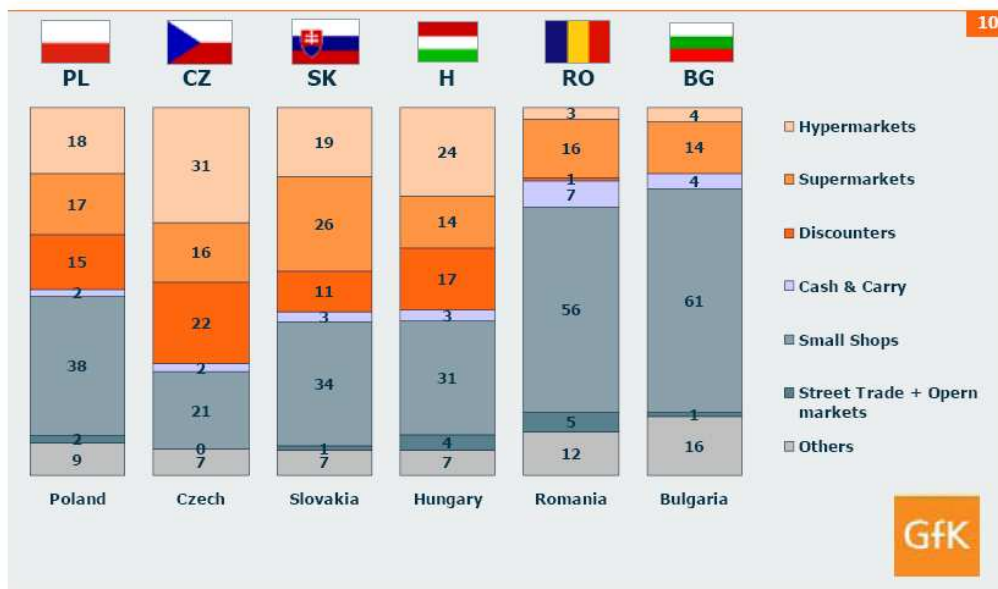
Hypermarket represents a retail format, which has achieved the highest increase of consumer preferences among consumers in countries of the Central European region. According to the GfK study - Shopping Monitor, hypermarkets are preferred as the main shopping place among 20 % of customers in the monitored Central and Eastern Europe (CEE) region. In the Czech Republic the penetration of hypermarkets is the highest in the Central European region. There are 16 hypermarkets per million inhabitants in the Czech Republic, compared to 14 in Slovakia, 8 in Hungary and 6 in Poland.

Discount stores are the main shopping place for 16 % of the households; however, their share shows stable growth in a long term and they are slowly replacing supermarkets, still the strongest retail format in the CEE region with its 24 % share.

Despite this general trend, there are still significant differences in shopping preferences of people in particular countries. The most developed retail markets of the Eastern European region are in Hungary, Czech Republic, Poland and Slovakia where hypermarkets stand very strong. In the Czech Republic and in Hungary, approximately 35 % of households prefer hypermarket as the main retail format when shopping for food, on the other hand hypermarket is a preferred food-shopping place for mere 1 % of households in Bulgaria and 6 % of households in Croatia (GfK, 2006).

Graph No. 6

## Trade Channels Market Shares in other countries January-June 2005



Source: GfK Praha

The differences in shopping behaviour have a number of reasons – historical, cultural and economic. This issue is the subject of many researches. Information on one of these can be found at [www.gfk.com/lifestyleresearch](http://www.gfk.com/lifestyleresearch) - it is a research of value orientation and attitude of inhabitants of particular European countries. Its core is a sociological research and the results are useful in strategy making and marketing of trading companies. You can find some useful information in the researches done by GfK. It is generally valid that consumers in Central and Eastern Europe show some interesting similarities and differences with their counterparts in Western Europe:

The no.1 value across the region (*i.e. Europe*) is protection of the family. Other values such as stable personal relationships, self-reliance, friendship and authenticity are high both in the (three surveyed) Central and Eastern Europe markets and (in the six surveyed) Western Europe markets” (GfK, 2006).

Whereas a minority of 38 per cent of Western Europeans is more interested in material possessions than in personal development, it is almost 46 per cent of Central and Eastern Europeans (GfK, 2005).

“It is often assumed that consumers in Central and Eastern Europe in particular are more prone to price watch. However, at 51% their pure focus on price (*i.e.* placing price considerations before quality) is scarcely higher than in the west (49%). In fact it is actually lower than in Germany (56%), with one exception – Poland – which ranks highest among all central and Eastern Europe countries (62%). But if we think about the rate at which markets are expanding in central and Eastern Europe this overall lower fixation with price (compared to Germany) is quite important, not to say positive” (Enke, 2005).

Marketing in the retailing often works with “buyers’ typologies”. Understanding the reasons and wishes of particular buyers’ types is important for the precise aim of services provided by retailing. The mentioned studies in Middle and Eastern Europe found out about this matter that despite all the differences in government systems and traditional structures, closer analysis of the value systems relating to consumption reveals that eight distinct consumer groups of varying lifestyles can be identified, which can also be found in Western Europe. However, whereas, for example, the consumption-oriented “dreamers” group constitutes 8 per cent of the West European population, the proportion in Central and Eastern Europe is one and a half times as many. Whilst the size of the individual groups still varies in both economic areas, the buying preferences and media interests of individual groups in Central and Eastern Europe are similar to those in Western Europe (GfK, 2005).

Another example - the most common shopping type in the monitored CEE region - is the “Thrifty Shopper” who represents more than 8.5 million of households, i.e. 17 % of the monitored population. This type of shopping behaviour is characterized by clear focus on price that is apparent mainly in usage of various special offers and action prices. The representation of the “Thrifty Shopper” differs throughout the monitored CEE region, though. It is the most common shopper type in Romania and Bulgaria where it reaches 29% and 23%, respectively, whereas this type is much scarcely represented in other monitored CEE countries such as Croatia with only 8% share, in Hungary (9%) or in the Czech Republic (11%) (GfK, 2005).

## 8.5 Appendix - definitions of retail formats

*Hypermarket* - very large store; a very large self-service store that sells products usually sold in department stores as well as those sold in supermarkets, e.g. clothes, hardware, electrical goods, and food.

*Supermarket* - big food store; a large self-service retail store selling food and household goods.

*Discount store* - store selling discounted merchandise; a store that sells merchandise at prices that are reduced from those recommended by the manufacturers.

*Cash and carry* – inexpensive store; a store selling inexpensive goods that are paid for in cash and taken away by the buyer. Cash and carry type usually means that the seller does not provide any more services than needed.

Sometimes the criterion of floor space is used to distinguish hypermarkets from supermarkets. Hypermarkets are then of the size of 2500 m<sup>2</sup> or more and supermarkets 400 m<sup>2</sup> – 2500 m<sup>2</sup> (Encarta, 2006).

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## 9 ADVERTISING IN THE CZECH REPUBLIC

The following chapter is concerned with the changes in the field of business marketing during the transformation of Czech economy. The main focus is on the present events. The topics will be the size of advertising industry in the Czech Republic, significance of marketing and marketing research in Czech businesses and special attention will be paid to advertisement and brands.

### 9.1 Advertising industry in the Czech Republic

A dynamic growth of the advertising market has been an integral part of the economic transformation in new member states of the EU. In fact, advertising is one of the most striking outcomes of this process. In the central planned economies, advertising as well as the expenditures on it had a marginal position. Speaking generally, the situation in advertising was far away from the practice of standard market economies. After the downfall of communism in Central and Eastern Europe, the advertising industry in these states began approaching the situation of traditional market economies.

Lots of new-established advertising agencies did not survive the rapid economical transformation at the beginning of the 1990s. The situation became consolidated during the late 90s. One of the reasons for that was the establishing of voluntary professional associations like AČRA M.K (the Association of Czech Advertising Agencies and Marketing Communication in 1992) or APRA (the Association of Public Relations Agencies in 1995).

The advertising spending amounted to 630 mil. Euro (17.76 billion CZK) in 2004 and the average annual growth was 5 per cent over last 5 years. The multinational firms are the largest advertisers, as Czech companies without foreign investors often find themselves in a difficult economic situation and advertising expenditure is not the priority for them (ARBOMedia, 2006; OMD, 2005).

Television has been the most popular medium for advertising, accounting for 46 per cent of the marketing budgets of predominantly large multinational firms. The second important medium in the Czech Republic is the press (34 per cent). Another form of advertising, which is less popular with advertisers in the Czech Republic, is outdoor advertising (8 per cent of total advertising expenditure) (OMD, 2005).

The share of the Internet ads came to approx. 4 per cent, however there are no exact figures - the Czech Publishers Association (Unie vydavatelů, 2005) estimates the ads spending on the Internet to 25 mil. Euro (760 millions of CZK) in the year of 2004. In accordance to OMD agency (2005) it should be 23 mil. Euro (710 mil. CZK). ARBOMedia (2005) estimates 10 mil. Euro (310 mil CZK). All research companies agree that the importance of this medium is increasing very quickly. The study of The Czech Publishers Association indicates the growth rate of almost 80 per cent in 2004. Quick growth of the Internet penetration among Czech citizens is the reason of that. Branches, which use the Internet as a means of advertising most often, are telecommunication as well as financial and automobile companies (Unie vydavatelů, 2005).

The survey of TNS Factum (2004) found out that 43 per cent of Czech companies use the Internet for marketing purposes (marketing campaigns or Internet ads). Most of the companies invest in Internet ads no more than 3000 Euro per year. Approx. 30 per cent of companies offer consumers the online shopping (TNS Factum, 2004).

In general the biggest submitters of advertisement in the Czech Republic in 2005 are these companies: Procter and Gamble (1,166 mil. CZK), T-Mobile (1,070 mil. CZK), Oskar-

Vodafone (918 mil. CZK), Eurotel (862 mil. CZK), Opavia-LU (744 mil CZK), Unilever (695 mil CZK), Volkswagen (651 mil CZK) nad Henkel (625 mil CZK). (TNS- A-Cnect, 2006)

The investments into advertisement are only a part of marketing expenditures of companies. According to the survey carried out by Brand Brothers agency, companies in the Czech Republic spent about 47 billion crowns, roughly 2.1 % of gross national product, on marketing in 2002. “Advertising has the highest share of total marketing costs (33.3 %). Direct marketing represents about one fifth of the expenses. Costs of personal selling amounted roughly to 6.9 billion crowns spent on personnel salaries... Out of the total amount of 47.140 billion crowns, promotional activities represent about 43.735 billion crowns, which is 92.8 % of total marketing costs. The remaining 7.3% is spent on salaries of marketing specialists and on market research.” (Brand Brothers, 2003). This fact suggests that market research is underestimated in the Czech Republic.

Table No. 18: Descriptive statistics of new EU countries

	Population (thousands) <sup>1)</sup>	GDP per capita (Eur) <sup>2a)</sup>	GDP per capita <sup>2b)</sup>	Advertising spendings (\$US Millions in 2002) <sup>3)</sup>	Advertising spendings as percentage of GDP in 2002	Internet penetration <sup>5)</sup>	Internet penetration (Internet access households) <sup>6)</sup>	Number of local domains <sup>7)</sup>	Online spendings <sup>8)</sup>
Czech R.	10203.3	14700	68.8	838	1.21	35	15 <sup>(2003)</sup>	724631	1.9
Cyprus	715.1	17600	82.2	105	0.92	n/a	53	39366	n/a
Estonia	1356.0	10400	48.5	64	0.11	46	31	237461	1.1
Hungary	10142.4	12900	60.5	931	1.41	21	14	611887	n/a
Latvia	2331.5	8800	41.0	85	0.35	27	15	63343	n/a
Lithuania	3462.6	9800	45.8	83	0.20	31	12	106458	1.6
Malta	397.3	15600	73.1	23	0.32	20	n/a	7825	n/a
Poland	38218.5	9800	46.0	2274	1.08	25	26	2482546	1.3
Slovakia	5379.2	11200	52.3	370	0.82	33	n/a	188352	n/a
Slovenia	1995.0	16400	76.8	301	0.51	50	47	48133	n/a
EU 10	74200.9		48.4 <sup>2c)</sup>	5074				4510002	

1) Data on thousands for the 1st of January 2003. Source: Eurostat.

2a) GDP (in purchasing power standards per capita) at current prices, 2004. Source: Eurostat.

2b) GDP (in PPS per capita) in 2003. EU25=100%. Source : Eurostat.

2c) Forecast of GDP (in PPS per capita, 2003) for the EU 10. Source: Czech Statistical Office

3) Advertising spendings in \$US Millions for the year 2002. Source: WARC „European Marketing Pocket Book“, 2004.

4) Source: WARC „European Marketing Pocket Book“, 2004.

5) Number of Internet users – in per cent of total adult population (over 16) in the year 2004. Source: FESSEL-GfK, Austria.

6) Percentage of households who have Internet access at home (year 2004). Source: Eurostat.

7) Number of local domains based on number of top-level domain in January 2005. Source: ISC Internet Domain Survey ([www.isc.org](http://www.isc.org))

8) Online spendings: The Internet turnover as percentage of the total turnover of enterprises with 10 or more employees. Year 2004. Source: Eurostat/National statistical institutes of respective countries.

It is not easy to find data, which would support this statement. Research on this subject has not been done in the Czech Republic yet. Only the Confess Research company elaborated a

study about market research among 18 large companies, but its conclusions cannot be generalized to small and medium enterprises. According to this survey the large companies do not think that they marginalize market research. However, they believe that in the Czech Republic there are not enough high-quality studies about B2B sector. The obstacle of greater exploitation of market researches is, in their opinion, limited utilization of such findings. The causes are in the quality of work of the research agencies and in communication (which can mean that the goal of research is not clear).

## 9.2 Marketing in Czech businesses

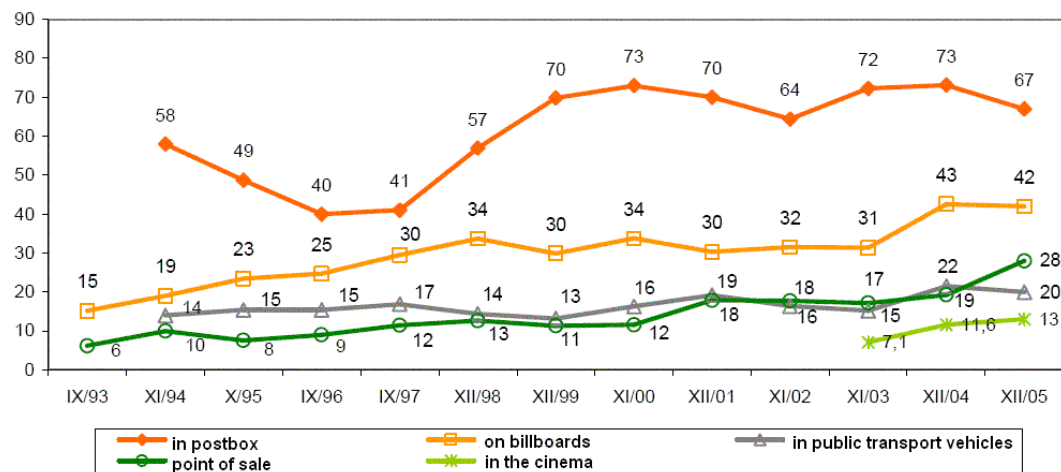
The Brand Brothers research in 2003 proved that the marketing penetrates Czech businesses only gradually. In example marketing department existed only in about 20 % of Czech companies of turnover more than 50 mil. CZK. In 18 % marketing is solved directly by the CEO and in 44% marketing is duty of commercial department. 17 % companies are not concerned with marketing at all. Most of Czech enterprises (61 %) do not do marketing or they leave it up to their sales channels.

Quite different situation is in large companies – all of them have a marketing department. Most often it is organised as a centralised marketing unit.

## 9.3 Consumers' perception of advertising intensity

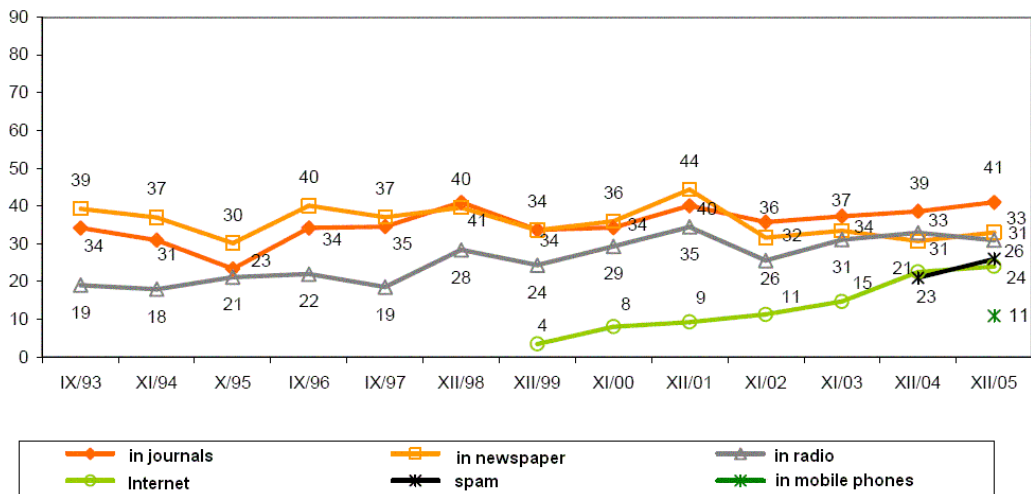
A different phenomenon is the (over)saturation by ads. This situation has been stable for a longer time, especially in the case of TV: in 2004, approx. 80 per cent of consumers felt to be oversaturated by ads on TV (it was 50 per cent in 1993). The intensity of ads in the radio and in the press was seen to be reasonable by majority of Czech population. Only a part of Czech population was able to form an opinion about the intensity of ads on the Internet. However the data shows a clear ascending tendency: in 2004 it was more than 20 per cent of Czech people who felt to be oversaturated by ads on the Internet. (It was 3 per cent in 1999). Less criticism is monitored in case of ads on point of sales (TNS Factum, 2006).

Graph No. 7: Level of over-saturation by ads (in per cents)



Source: TNS Factum

Graph No. 8: Level of over-saturation by ads (in per cents) - continuation



Source: TNS Factum

## 9.4 Consumers' perception of advertising content

The consolidation of advertising market positively affected attitudes of Czech consumers. Most of them (75-80 per cent in 2004- according to the survey of TNS Factum company (2006)) see advertising as a natural part of modern lifestyle. However, the relationship of Czech people to advertisements is rather ambivalent. More than 80 per cent of consumers perceive advertisements as a means of manipulation, but only 30 per cent of consumers admit that they were affected by advertising in their shopping decisions. We can assume that advertisement influences people more than they admit. Many of them do not realize this fact and part of the population is not willing to admit it.

The consumers' opinion on the content of ads is also a subject of TNS Factum surveys. It is not surprising that the expectations toward ads have been stable for several years. The answer to the question what an advertisement should be like is following: truthful (55 per cent of responses), trustworthy (39), witty (34), informative (34), comprehensible (34), not obtrusive (29), attract people's attention toward the product (26), easy to remember (23) and original (20).

According to the survey results, people do not put emphasis on artistic or on linguistic quality of ads. The factor of advertisements' origin (whether it is a national or foreign ad) is not very important either. (TNS Factum, 2006) Concerning ads for alcoholic drinks, Czech community prefers to limit them instead of a strict ban. Czechs are also traditionally benevolent to ads with erotic incentives.

## 9.5 Czech consumers and the role of brands

During the period of transformation, utter disintegration of shopping and consumer habits took place. The customers ceased to buy many of their formerly favourite products and they also stopped shopping in their traditional shops. There was a considerable loyalty decrease in relation to both the shops and many brands. That is why the matter of brands' meaning is somewhat specific in comparison to other new EU countries.



The brand products are preferred by approximately 40 % Czech consumers – most often while buying electronics, beer and wine. Other product categories follow with some distance (perfumery, other alcoholic drinks). The main reason for buying brand products is their higher quality for 85 % of Czechs (Factum Invenio, 2004), despite the fact that approx. 40 % Czech customers have negative experience with brand products.

Generally best-known domestic brands in the Czech Republic are, according to DATAMAR research, Škoda Auto, electrical appliance manufacturer ETA, Pilsner Urquell, Baťa, Tesla, Budweiser Budvar, Tatra, Vitana, OP Prostějov and Orion. From the subjective evaluation point of view (that means the positive relationship to a brand) the following brands have the best positions: Tatranky, Bohemia, Nova, Pilsner Urquell, Tradiční české brambůrky (HN, 26. 3. 2004). We can mention the world's best brands: Coca-Cola, Microsoft, IBM, GE, Intel, Nokia, Disney (Interbrand, 2005).

Concerning the trends, we can state that the international brands are strengthening and their popularity grows beyond that of the Czech brands. According to Focus company, the main reason is the lower level of promotion of Czech brands and narrower assortment of Czech producers. Another issue is the success of private labels of retail chains, which is a relatively new phenomenon in the Czech Republic. The attitude of Czechs is rather positive: i.e. more than half of the inhabitants evaluate the quality of these products as comparable to other goods (Moderní obchod, 4/2004). The share of private labels was about 5 % in retail. We can assume that their importance on the Czech market will grow since the European average is 22 % (HN, 28. 1. 2005).

If we compare the attitude of Czech customers to brands, lower dependence than in other new EU countries is remarkable. For example company Median confirms this statement with its research in the field of clothing and shoes. About one quarter more Slovaks than Czechs bought brand shoes or clothes (Moderní obchod, 4/2004). The causes need to be searched for in cultural differences among the particular countries.

## 9.6 Ethics of Advertising

As we mentioned earlier, voluntary professional associations like AČRA M.K or APRA helped to improve the quality of the Czech market environment. A very unique role in this field was played by Rada Pro Reklamu (Czech Advertising Council). It is the Czech advertising self-regulatory organisation founded in 1994, which adjudicates on the ethical complaints from the public regarding advertisements in all media. It is modelled on the UK system of self-regulation. Hence, it has no legal power, but its decisions are accepted by the majority of marketing agencies (Rada pro reklamu, 2004).

Advertising is regulated in the Czech legislation in the same way as any other activity. However, some advertisements are not illegal but break moral or ethics rules. Such incidents endanger the (good) name of advertising and decrease trust of advertising as a service provided to customers. Therefore these incidents are not good for the whole branch. That was the reason for foundation of the self-regulating institution – Czech Advertising Council. This council only says whether the particular ad broke rules of the “Code of Advertising” or not.

The Czech Code of Advertising is practically identical to the Code issued by International Chamber of Commerce. It sets up the rules for professional behaviour and informs about the limits which were voluntarily accepted by the subjects engaged in or using advertising.

The Czech Advertising Council has to solve about 60 – 70 complaints yearly. People in the Czech Republic are mostly bothered by false and misleading advertising, which is a long term trend. From the medium point of view, people complained mostly about TV ads – they

accounted for approx. 35 % of the complaints (Rada pro reklamu, 2006). In 2005 the “copy advice and pre-clearing” was introduced by the Czech Advertising Council, which is a consultancy service enabling advertising companies to check their advertisement campaign before it goes public. This prevents many problems.

We can say that the regulation of advertisement, based on self-regulation, works fine according to the results achieved and can be a representative model for other fields of entrepreneurship.

## 9.7 Appendix – 1: The Case of Poland

The rapid growth of the advertising market was typical for the beginning of transformation process of Polish economy. Through the years 1996 – 1999, the average annual growth was over 40 per cent due to the structural changes in the economy and due to the economic boom of that time. Polish advertising market followed a slowdown of national economy from 2001 until 2003 and went through a severe recession. The other reason for recession (of outdoor ads, especially) was the introduction of legal restrictions aimed at tobacco advertising. The biggest Polish publisher Agora (2005) estimates that total advertising spending declined by 14 per cent in 2003. The total ads expenditures came to 2.411 mil. Euro (11.3 billion of PLN). The recession was most painful for the daily press, particularly national newspapers (37 per cent shrinkage of advertising revenue). The recovery started in 2004 when advertisement spending went up by 12 per cent (Agora (2005).

Concerning the media shares in 2004, TV has a dominant position in the advertising market in Poland (48 per cent). Press, the second largest segment, holds around 35 per cent market share. The radio and outdoor advertising hold 9 per cent and 8 per cent, respectively (Agora, 2005). On-line advertising still remains far behind traditional media: its share is around 1 per cent of the total advertising market in Poland (estimation of Zenith Optimedia agency, 2004). Branches, which use the Internet as a means of advertising most often, are telecommunication (37 per cent of ads spending on the Internet), as well as financial and automobile companies. (Agora, 2005)

## 9.8 Appendix – 2: The case of Hungary

The data about the size of the advertising market in Hungary (as in other New Member states) are only estimated. According to the Budapest Business Journal (BBJ, 2004) the value of TV commercial spots was estimated at 213 mil. Euro (Ft 55.8 billion) in the year 2003. The printed press ranked on the second place with 212 mil Euro (Ft 55.7 billion). The next favoured medium was outdoor advertising and the radio with annual advertisement value of 43 mil Euro (Ft 11.3 billion) and 34 mil Euro (Ft 9 billion) respectively.

According to the Hungarian Advertising Association, the online advertising market has expanded by approx. 30 per cent in 2003 thus reaching a 2 per cent share of the total advertising market. Important stimuli for such a growth are the increase in the number of Internet users by 15 – 20 per cent and the spread of broadband connections. The largest online advertisers include car dealers, telecommunication companies, beer makers, and cosmetics firms (BBJ, 2003).

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# 10 MOBILE COMMERCE IN THE CZECH REPUBLIC

## 10.1 Introduction

M-commerce has been a frequently discussed issue lately. This expression has arisen with the development of mobile technologies and new payment methods. M-commerce could be defined as a kind of business transaction realized through electronic transmission elements, among which is a mobile terminal (mobile phones, PDAs) often as the first or last component. The following text attempts to describe the situation in m-commerce from the marketing point of view – to point out the research question, which has arisen out this field for marketing.

## 10.2 Definition of m-commerce

The meaning of m-commerce is inherently connected to the continuous development of mobile networks<sup>15</sup> and e-technologies in general and to the development of electronic payment systems. Mobile network carriers and service providers are part of m-commerce as well; the payments for extra services provided are added to a mobile telephone user's bill, deducted from their calling credit or realized via premium-rate calling numbers or charged SMS.

Another definition (by “Úřad pro veřejné informační systémy”<sup>16</sup>) says that m-commerce is a set of processes connected to realization of business transactions and executed via mobile technologies in real time (on-line). M-commerce is usually treated as a subset of e-commerce.

M-commerce finds use in the area of electronic business B2C (Business to Customer) and B2B (Business to Business). The m-commerce applications:

Content services (e.g. news, dictionary)

Messaging – transfer of information (e.g. SMS)

Remote Access/Mobile Office (access to an intranet of a company)

Emergency Services (e.g. missing persons)

Video and audio data – typically via UMTS

Entertainment – games, lottery, SMS competitions ...

Tailing – shopping, ticketing and reservation services

Financial Services – banking and broking

Payments – realization of payment operation via mobile phones

Navigation – Global positioning system

Telemetry – automatic data exchange between machines<sup>17</sup>

Marketing applications - SMS surveys, sending company logos as wallpapers for free, loyalty programs counting points via SMS

← Naformátováno: Odrážky a číslování

<sup>15</sup> The idea that highly profitable M-commerce applications would be possible though the broadband mobile telephony provided by 2.5G and 3G cellphone services was one of the main reasons for hundreds of billions of dollars in licensing fees paid by European telecommunications companies for UMTS and other 3G licenses.

<sup>16</sup> <http://www.park.cz/article.asp?itm=159>

<sup>17</sup> BÖCKER, J.; Quabeck, S. *Neue Dienstleistungen im Mobile Commerce. Neue Dienstleistungen im Mobile Commerce*. In: Silberer, G.; Wohlfahrt, J.; Wilhelm, T. (Hrsg.): *Mobile Commerce*. Gabler, Wiesbaden 2002, S. 205-228

Apparently the oldest applications of m-commerce were the distribution of logos and ring tones, advertising messages, downloading of games and arranging of prize competitions. Other examples of wide-spread m-commerce applications are information-on-demand systems like news services (sports and entertainment info on the first place) or stock tickers, banking and stock brokerage applications by SMS, WAP or MMS. Shopping and reservation services (e.g. movie tickets, parking tickets, tickets for public transport, etc.) are now more accessible when using mobile devices, as the verification of someone's ID or authorization of reservation is less problematic. The entertainment industry will be able to promote wireless gaming and music. Corporations are also using m-commerce to expand everything from services to marketing and advertisement<sup>18</sup>.

Banks and other financial institutions are exploring the use of m-commerce to broaden their business by allowing their customers not only to access account information, e.g. bank balances, stock quotes and financial advice, from anywhere, but also the possibility to make transactions, e.g. purchasing stocks, remitting money, via mobile phones. This service is often referred to as Mobile Banking or M-Banking<sup>19</sup> (Wikipedia). The basic incentive of m-banking is to enable payments for goods and services at anytime and anywhere by means of a mobile. Mobile phones in hands of customers represent an already built-up base of new payment infrastructure, into which it is not needed to invest again. Mobile carriers have roaming deals in most countries worldwide, therefore they can secure payments almost from anywhere in the world.

For the customer the speed of fulfilment of payments is an advantage as well as the comfort of this system, especially in case of micropayments, which mean considerable savings of the transaction costs. Mobile phones are more available than the internet and are movable to any place. In addition, people trust mobile phones more than they trust the internet<sup>20</sup>.

As main contributions of m-commerce we can consider customer satisfaction, cost savings, and new business opportunities, particularly when larger screens of mobile devices will stop limiting the complexity of applications.

### 10.3 Technology bases of mobile commerce

To be able to speak about mobile commerce certain level of technology is needed. M-commerce is currently built on this mobile communications infrastructure: GSM (Global System for Mobile Communications), which represents the 2<sup>nd</sup> Generation of Mobile communications and its suitability for m-commerce is thwarted by its limited bandwidth of 9.6 Kbps (Kbits/sec). The alternative 2.5<sup>th</sup> and 3<sup>rd</sup> generation technologies (HSCSD, UMTS) are also available in many countries nowadays. Particularly the UMTS network supports a wide range of voice, data and multimedia services and thus creates a huge potential for m-commerce applications.

The other condition for successful m-commerce is the high penetration of (relatively) advanced mobile phones...

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<sup>18</sup> Although there are currently very few regulations on the use and abuses of mobile commerce, this will change in the next few years. With the increased use of m-commerce comes increased security.

<sup>19</sup> The banking license is necessary for realizing of payments, though. Some mobile carriers, that do not want to be only mediators between a customer and a bank, have already applied for a bank license.

<sup>20</sup> Cell phone companies are now spending more money to protect their customers and their information from online intrusions and hackers.

## 10.4 M-commerce in the Czech Republic

### 10.4.1 Mobile network operators in the Czech Republic

There are three mobile network operators in the Czech Republic. Eurotel Praha, Ltd. was the first operator in the Czech Republic. It is the biggest provider of wireless voice and data services in the Czech Republic. It portrays itself as the technological leader at the Czech market. The company was overtaken by Spanish Telefónica in 2005 and it was rebranded to „Telefónica O2 Czech Republic, Inc.“

Paegas – nowadays T-Mobile Czech Republic – was the second GSM provider in the Czech Republic (started in 1996). Oskar was the third operator in the Czech Republic (commercial launch in the year 2000). Majority of its customers came from the consumer market in the beginning. The company is now set to focus on the business segment too. Oskar was overtaken by Vodafone Group Plc. in 2005 and rebranded after its controlling company in the following year.

The offer of Czech mobile operators is built on the base of the following technologies and services: GSM, GPRS, WAP HSCSD, WiFi, MMS, EDGE, UMTS and CDMA 2000.

Table No. 19: Penetration of SIM-cards in the Czech Republic

<i>Provider's name</i>	<i>GSM</i>	<i>3G licence</i>	<i>No. of activated SIM cards (2005)</i>
O2	Yes	Yes	4 680 000
T-Mobile	Yes	Yes	4 630 000
Vodafone	Yes	Yes (not operating yet)	2 140 000

Source: O2, T-Mobile, Vodafone

As for the attitude of the operators to m-commerce, and especially to mobile marketing, Zálešák (2003) schematically divides the mobile network operators in the Czech Republic into two groups. The first group consists of T-Mobile and Vodafone, which take passive-active approach. Both operators use mobile marketing for communication with their own customers and they also facilitate use of these services for third-parties. The second group consists of O2 with its proactive approach, which means that its offer in the area of mobile marketing for its business clientele (including smaller firms) is wider. For example, it is O2 as the only company offering mobile marketing at its internet SMS gate.

### 10.4.2 Mobile phones penetration and use of mobile services

A mobile phone is the most popular technology among individuals in the Czech Republic. According to the SIBIS General Population Survey (2003), mobile phone use has been very high in the Czech Republic in comparison to other countries. The number of mobile phone subscriptions per 100 inhabitants was 95 percent<sup>21</sup> in the year 2003. This fact ranked the Czech Republic on the fourth place in the world<sup>22</sup>. In the year 2005 the number of mobile

<sup>21</sup> As one person may have more than one subscription, the number of subscriptions can be higher than the population.

<sup>22</sup> Eurostat. *Around 80 mobile subscriptions per 100 inhabitants in the EU25 in 2003*. Eurostat news release, 20/2005, 7 February 2005.

phone subscriptions per 100 inhabitants was 111 per cent<sup>23</sup>. Approximately 5 % of the population does not own a mobile phone. That means that part of the population uses more than one SIM card – i.e. have more than one telephone number. It should also be noted, that several percent of SIM cards are used for technical purposes (e.g. machinery control) and are not used for telephony.

Not surprisingly, mobile phone ownership correlates with age: the younger the age group, the more mobile owners. The youngest group (up to 24 years) uses the mobile phone of all groups the most and it also uses more possibilities it offers. The smallest percentage of mobile users (5 per cent) is in the oldest age group (65 years and more), and the use of advanced mobile phone services is lower<sup>24</sup>.

SMS is a much favoured and frequently used service, directly following phone calls themselves. Number of SMS per one active user in the Czech Republic was the highest in Europe in 2002 – approximately 4.8 to 5 billion of SMS were sent within all three local mobile networks (Zálešák, 2003). Some customers prefer this service because of the price, which is lower than the price of calls. SMS use correlates with age as well. The highest proportion of SMS users is found in the youngest age group. 92% of young mobile owners (aged up to 24) use SMS in contrast to only 30% of the oldest age group<sup>25</sup>.

### 10.4.3 Mobile commerce

There is only limited information available as to the extent of mobile commerce. According to a survey conducted by the Czech Statistical Office (2005) mobile commerce is used by less than 10 % of mobile phones owners. The survey also shows that GSM banking is the most widely used mobile commerce service.

People using the Internet can be seen as a particular group – pioneers of m-commerce. Mediaresearch agency's research reveals much more frequent use of GSM banking (23.2 %), downloading of logos, melodies, ring tones, etc. (22.4 %) in this group. Frequency of playing games, which reaches 34.1 %, is interesting too. Teenagers are another interesting group from the viewpoint of mobile operators. Approximately 14 % of teenagers who are using mobile phones download games, 25 % download pictures and 37 % download ring tones (Rakowski, Mertin, 2005). Data about this structure is confirmed by the Czech mobile operators as well (e.g. mobile Java games were downloaded about 3 times more in 2005 than in the previous year) (Marketing&Media, 2006). These pieces of information can be generalized to the statement that mobile commerce in the Czech Republic is currently concentrated on less sophisticated activities.

M-commerce revenues of mobile network operators in the Czech Republic will amount to 17 million Euros<sup>26</sup> (according to estimates of experts). As far as mobile marketing as a subset of m-commerce is concerned, Zálešák (2003) estimates its volume based on his computations at around 200 million CZK in 2003. Mobile marketing in the Czech Republic is mainly used by well-established companies such as Unilever, Kenvelo, Vogel Burda Communications, Škoda-Auto or Pirelli (Zálešák, 2003).

Concerning the expectations in the field of m-commerce, they are mainly connected with the development of 3G networks and technologies. Roland Berger Market Research (End-User Survey Czech Republic, 2005) indicated that Czech users put the biggest expectations in the

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<sup>23</sup> T-Mobile loni vydělal skoro pět miliard. *Idnes.cz* 2.3.2006

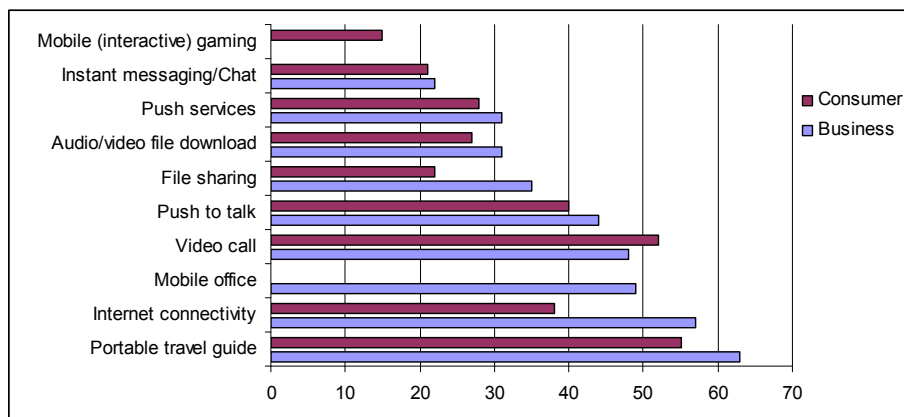
<sup>24</sup> *SIBIS 2003, Czech Republic, Country Report No.2.* p.20

<sup>25</sup> *SIBIS 2003, Czech Republic, Country Report No.2.* p.20

□ *Computerworld.cz. Mobilní obsah: Dobrá příležitost si vydělat* 26.07.2005

service of the Portable travel guide, which will be improved fundamentally due to 3G networks. Another service – video calls – seems to have high potential as well, because it brings new emotional factor into the electronic communication. The research also shows that Czech users expect rather low prices for these services, which is a very optimistic expectation...

Graph No. 9: Which services do Czech people expect from mobile phones? (Answers in per cents)



Source: Roland Berger Market Research (End-User Survey Czech Republic, 2005)

#### 10.4.4 Mobile gaming

Users in the Czech Republic downloaded approximately 50 000 copies of games per month, and paid about 1.4 million Euro for them<sup>27</sup>. Number of mobile games players is increasing as the penetration of suitable devices is rising too. As stated before, mobile games are being downloaded most frequently by users 13 through 19 years of age. This very age group – young mobile phones users – is then actually playing the (installed and downloaded) games. Zdražil (2006) shows that, according to the March Vodafone company survey, mobile games were played by about one half of Czech customers between 15 and 24 years of age. 65 % of regular “daily players” are women. But men are still more interesting from the meriting point of view as they download the games (download of one copy of a game is worth of 1 – 3 Euros), where as women are often satisfied with games that are distributed with their mobile phones. The most popular games are downloaded by up to 15 000 Czechs per month. “We are witnessing a trend of our customers rather purchasing more costly games of higher quality,” spokeswoman for O2 company has said (Marketing and Media, 26.4.2005).

#### Mobile banking

All the three operators offer GSM Banking. Apart from that, T-Mobile has come with “m-payment” service, which is so far the only working system of payment through mobile phones, still limited, however, compared to the possibilities. Prepaid and postpaid customers can use this service when purchasing goods at only a handful of Internet shops. The advantage of this service lies mainly in the area of security, so needed in the Internet environment. There is not much public information about these activities available now.

<sup>27</sup> Computerworld.cz. *Mobilní obsah: Dobrá příležitost si vydělat* 26.07.2005



The three Czech operators together with the five biggest banks founded the Association for mobile payments. Its goal is to stimulate the use of mobile technologies for financial services at the Czech market. Creating standards for mobile payments should be the mean of reaching this goal. However, activity and effort of this association is rather low so far.

## 10.5 Internet and e-commerce

Because m-commerce belongs to the group of e-business, let us have a look, how the things are in this field in the Czech Republic.

Nearly 30% of Czech households were equipped with a personal computer in 2005 (Czech Statistical Office, 2005). The Internet penetration grows steadily in the Czech Republic. Nowadays, the Internet is used by 35 % of adult population in the Czech Republic. That is almost twice the number of Internet users in 2000. The Czech Republic thus clearly outmatched other countries of central European region, e.g. Bulgaria (16 %), Hungary (22 %) or Poland (31 %). But it still does not reach the levels of penetration in Estonia (51 %) or Slovenia (56 %). Most dynamic advancement can be seen with older people (GfK, 2005), despite the fact that Internet use still remains the domain of younger people. A quarter of Czech citizens have the Internet connection at home<sup>28</sup>.

Searching for information is one of the most frequent activities on the Internet, according to the survey of the Czech Statistical Office (2005). During the period of last 3 months, 62% of Internet users used the Internet for finding information about goods and services, 54% used it for finding and downloading professional texts, 38% for looking for services related to travel and accommodation, 36% for reading and downloading on-line newspapers and magazines, and 28% for playing or downloading games and music.

E-commerce involves only a part of the population of Internet users. The current stage of e-commerce development in the Czech Republic is based on historically low level of the mail order market during the past 40 years, in comparison to the rest of Europe. This market, which is similar to the B2C commerce, has no tradition in the Czech Republic<sup>29</sup>.

Almost 3 million Czech customers made a purchase over the Internet in 2005. Overall numbers show that about 85 % of Czech Internet population have already experienced purchasing goods and services through the Internet. Online shopping is attractive to younger age groups up to 29 years (in comparison to older age groups). Most online purchases in 2005 involved books, magazines, computers, electronics and toys. The most favoured online service was “photo-services” and online purchase of tickets for cinemas, theatres and also booking of trips, travels and accommodation (ONLINE SHOPPING 2005, GfK.27.2.2006). Due to the permanent pressure of banks, most banking operations and current account payment orders have been transferred to online banking<sup>30</sup>.

Approximately 12.5 thousand of Czech enterprises purchased goods or services via the Internet in 2003 – that is almost 30 % of the total number. The value of Internet purchases achieved 2.8 % of total purchases and the value of Internet sales achieved nearly 2.1% of total sales in these enterprises.<sup>31</sup>

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<sup>28</sup> *Čtvrtina obyvatel ČR má doma připojení k internetu*. Factum Invenio. Published on 18.1.2005. URL: [www.factum.cz/](http://www.factum.cz/)

<sup>29</sup> *SIBIS 2003, Czech Republic, Country Report No.2*. p.34.

<sup>30</sup> *SIBIS 2003, Czech Republic, Country Report No.2*. p.45.

<sup>31</sup> Czech Statistical Office, Results of the Survey on ICT Use in Enterprises of the Czech Republic 2003, Published: 28.12. 2004. URL: <http://www.czso.cz/eng/edicniplan.nsf/publ/9602-04-2003>

To sum up, m-commerce in the Czech Republic is limited to its basic types (sending of logos and ring tones, voting, advertising SMS). There are no reliable data (or are not publicly available) about the extent of these activities.

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