Course title: Selected economic and financial risks

Topic 1 : Economic and financial risks and their types

T1 processors:
Ing. et Ing. Jana Boulaouad, Ph.D.
Ing. Vojtěch Müllner

Objective of the course - aims of the **course unit:** To acquaint students with the concept of risk and its application in the field of economic and financial decision-making.

Aim of the topic: To clarify the concept of risk and its classification in the financial field. Focus on basic concepts related to financial planning.

Tasks for work:

1. What is risk and what factors influence its existence?
2. How can the significance of a risk be determined?
3. How can the relationship between risk and uncertainty be described?
4. What attitudes can an investor take to risk and how does risk affect investments?
5. What are the main principles and principles of financial planning?
6. What are the main financial management processes of public sector organizations?
7. What is the stage of creating a public budget?

Content:

- Financial risk and its classification
- Risk classification
- Identification of risks and determination of their significance
- Factors influencing risk
- Other related terms
- Investors' attitudes to risk
- Basic concepts in the field of financial management
- Financing

- Financial planning
- Concepts and problems associated with the preparation of a financial plan
    - Planning horizon
    - Structure of income and expenditure
    - Compensation for excess cash
    - Compensation for lack of funds
- Determination of the minimum cash balance

 Financial planning in the public sector

- Budget process

Financial risk and its classification

In the area of corporate finance, under the term **risk,** we perceive the danger that the actual results will differ from the results we expect, both in a negative direction, ie that the actual results will be worse than expected; as well as in a positive direction, ie that the actual results will be better than expected. The risk and its assessment is also associated with a description of the investment, the profit of which is not known in advance with absolute certainty, but for which a certain set of possible results and their probabilities are known. [1]

Financial risks are risks associated with financial activities and are subject to risk management.

Risk classification

The basic division of financial risks is into credit risk, operational risk, liquidity risk and market risk. *Credit risk* is otherwise referred to as credit risk and is one of the basic financial risks. This includes, for example, the risk of outstanding loans, outstanding invoices, etc. *Operational risk* is based on the organization's operations, so it is associated with, for example, failure or lack of resources to ensure the organization, etc. (failure of procedural, human, systemic or external influences). This includes all risks that we would not classify as credit, liquid or market risk groups. From a liquidity perspective, we talk about the organization's ability to meet its obligations at all times. *Liquidity risk* is therefore associated with the inability to repay client deposits and other liabilities to suppliers, for example, in the required time and form. Market risk is the risk arising, for example, from price movements and their impact on the company's value (equity value or profit). For this reason, the amount of market risk is affected by the sensitivity of the company's asset items and costs and revenues to changes in market prices. According to the nature of market prices, the changes of which we evaluate, the classification of market risk is divided into: currency; interest, stock, commodity. [2]

Identification of risks and determination of their significance

The risk can be approached from the point of view of its probability and on the basis of it the risks can also be measured. The **level of probability** is used to calculate the risk . Probability can be defined as the possibility of the occurrence of a certain event, while its value is in the interval (0–1 ; 0–100%). If the probability of the occurrence of a certain event is equal to one, then it is a certain phenomenon or a situation where there is no uncertainty. On the contrary, with zero probability, it will be an impossible phenomenon, ie a phenomenon that can never occur. The sum of the probabilities of all possible events of a certain phenomenon will be equal to one. Thus, if the company faces, for example, three possible demand situations, of which high demand with a probability of 0.2 and average demand with a probability of 0.5, then the probability of the last possible situation, ie in our case low demand, will be equal to 0, 3. We distinguish two approaches to measuring the probability of risk: [3]

- Objective measurement of probability - is based on repeated observation of a certain phenomenon and the results that are caused by this phenomenon.
- Subjective measurement of probability - based on the courts and opinions of those we consider experts; prevails in economic practice.

Factors influencing risk

The emergence of risk is caused by the existence of uncertainty in the process of making (financial) decisions. Uncertainty is due to the inability to reliably determine the future results of our decision, which are given by two basic types of factors [4] :

- Internal factors - internal so-called subjective factors are the consequences of the decision itself. This includes reorganization, working conditions of employees and satisfaction with them, etc.
- External factors - referred to as the so-called objective, we include among them, fluctuations in input prices, the effects of political changes, natural disasters, etc.

Other related terms

A portfolio is a combination of assets for investment purposes. (Narrower term - in relation to securities). This is the entire left side of the balance sheet, all the assets of the company (broken down by the purpose for which these assets were acquired - for example, assets intended for investment on the capital market). [5]

Diversification = the main principle in portfolio creation is the principle of diversification (risk allocation). This area is also mentioned in the risk prevention section. The logic of diversification is that at a time when one asset is experiencing "bad times" (low returns), other assets with "good times" (high returns) reduce the impact of declining returns on the first assets on the company's overall financial position. [6]

From the point of view of the principle of diversification, we distinguish [7] **:**

- **Unsystematic risk** - a risk that can be reduced or even eliminated through diversification is a risk always associated with a certain security.
- **Systematic risk** - expresses a danger common to all companies, for the whole market, and therefore cannot be reduced or eliminated on the basis of diversification.

Investors' attitudes to risk

From the point of view of financial management, three basic attitudes of investors to risk can be distinguished : aversion, inclination and neutrality [8] :

a) **risk averse investor** - does not like risk and tries to avoid it. It therefore behaves in the same way as a rational investor, and who, under otherwise the same conditions, prefers less risk to more.

b) **risk** - **prone investor** - prefers investment projects that have a higher risk with the same expected returns.

c) **risk-neutral investor** - in essence, they ignore the existence of risk and choose to invest the portfolio only on the basis of their expected return.

Also from the point of view of microeconomic theory, on which the above is based, we can monitor the level of benefit of the consumer from a certain amount of money in terms of risk . People vary in their willingness to take risks [9] :

1. A person averse to risk (most people) is characterized by basic characteristics in his decision-making:

- a certain result is preferred over a risk with the same expected result;
- calls for a relatively high probability of the highest possible outcome of a risky alternative in order to be indifferent between a certain and a risky alternative;
- the utility function is in this case so-called concave - with increasing incomes the total utility increases, but to a declining extent, as there is a decreasing marginal benefit from income;

2. person looking for risk (eg bettors)

- willingness to take a risk even with a relatively small probability of the highest possible outcome of a risky alternative;
- the utility function is convex, ie with an increasing marginal utility of income - the utility grows faster than the consumer's income;

3. a person indifferent to risk

- this type of person is indecisive in choosing between a certain and a risky decision alternative, if a certain result is identical with the expected result of the risky alternative, the utility function is linear (the line passes through the beginning).

For risk aversion, we can distinguish three basic levels: **weak, moderate and strong.**
Investor with a strong risk aversion - prefers, albeit at the expense of higher returns, risk-free

portfolios or associated with only very low risk and is therefore in the lower part of the effective limit. Even an **investor with weak aversion** - is looking for projects in the upper part of the effective limit, as he will sacrifice certainty in favor of higher returns, and therefore he will prefer portfolios with higher risk. Even an **investor with a moderate aversion** - his requirements for return and risk are approximately in balance. It will invest in projects located in the middle of the effective frontier. [10]

The degree of risk aversion depends primarily on the personal nature of managers and their motivation system. Short-term involvement and the disparity between success and penalty penalties can lead to very prudent behavior and the choice of rather less risky investment options. An important factor is also the economic position of the company: stronger companies can afford to take more risk, weaker companies, on the other hand, are forced to take risks, precisely in order to survive in the market. [11]

Relationship to risk and willingness to accept the so-called. Fair bet: [12]

The following section very logically describes risk decision-making based on the theoretical basis of the so-called fair bet. A fair bet is a type of bet whose expected result is the same as the initial certain amount, for example, a situation where we have CZK 50, and there is the same chance that I can win CZK 100 or lose everything, ie have CZK 0.

In this case, the types of risk decision makers described above behave theoretically as follows [13] :

- a person with an aversion to risk prefers the alternative of certainty to a fair bet;
- the person seeking the risk prefers the alternative of a fair bet to the certainty (it brings him greater benefits);
- a person with a risk- neutral relationship is indecisive in choosing between the alternative of certainty and fair betting.

People often insure themselves against risks, which is the most common approach to risk even for those with a risk rejection (risk aversion). [14]

BASIC TERMS IN THE FIELD OF FINANCIAL MANAGEMENT

Financing

Financing means obtaining financial resources, or more generally capital in all its forms, and their use to procure the necessary goods, to cover expenses for the activities of the organization, etc. Financing is an important cross-cutting activity connecting all materially specialized activities taking place in the organization. There are several aspects according to which we can differentiate financing in the company. For example, according to the regularity of financing, we distinguish: common; extremely. *Current financing* means ensuring the normal operation of the organization, it mainly concerns current assets (current assets include: receivables, cash on hand, money in accounts, inventories or short-term securities). *Extraordinary financing* is used in the establishment of a company, its expansion, merger, rehabilitation, liquidation. [15]

Financial planning

Basic principles and tasks of financial planning

The financial plan and the reality of the values stated here are affected by the way in which the principles of financial planning are observed: Systematicity; completeness; clarity, glide, flexibility, periodicity. Principle of systematicity: the systematic pursuit of a basic objective to which the objectives of other levels must be subject. The principle of completeness is based on the requirement to include the full structure of activities and factors in the planning process. The principle of clarity allows anyone who uses the financial plan easy to operate and control. Periodicity is associated with the requirement to draw up a financial plan in successive regular periods. The principle of flexibility is linked to the updating of planned values during the planning process. The principle of slip is linked in particular to the last two and consists in the requirement that the planning horizon of the new financial plan partially overlaps the planned horizon of the previous financial plan. [16]

The last is the principle of coordination. Temporal and spatial coordination is based on the requirement to harmonize the process of short-term and long-term financial planning. In the case of a short-term plan, information from the long-term plan (for example, information on planned investments, profit distribution strategy, etc.) will be taken over there. Spatial coordination is based on the harmonization of individual economic plans of the organization. If we take the production organization as an example, then the production plan is followed by a production plan, based on the production plan are then based plans of individual centers (production and service) and cross-sectional plans - ie across centers, which are supply plans, personnel or investment . The necessary basis for coordination is the motivation of employees to create real and complete documents for the needs of financial planning. [17]

If financial planning, resp. financial plans to fulfill their role in the financial management of the company, it is necessary in the financial planning process to respect certain basic principles and guidelines: [19][20]

- ***Cash flow preference principle:*** *This principle emphasizes that, in both the short and long term, aggregate cash inflows outweigh total cash outflows; Although this requirement is, of course, logical, in business practice it is very often possible to meet with the opinion that the decisive aspect of financial management are such categories as profit, revenues or costs. The requirement of cash flow preference mandates to distinguish profit growth from cash flow growth, income from income and expenses from expenses, and therefore it would be a mistake to automatically consider a profitable business as a financially sound business. In practice, cash flow preference is particularly important in liquidity management and is used as an essential factor in investment decisions. "*
- *"* ***The principle of respecting the time factor:*** *The essence of this principle is to prefer earlier income in financial management over later income, if the nominal value of the compared income is the same. In practice, this principle is applied in particular when evaluating the effectiveness of investments using the net present value method. "*
- *"* ***The principle of respecting and minimizing risk:*** *One of the foundations of sound financial management is that the same amount of money earned with less risk should take precedence over the same income earned at the cost of more risk. The importance of this principle is given by the fact that business is objectively burdened by a number of risks and the effort of financial management is (among other things) to minimize risk - but this does not mean that the least risky alternative is always the most advantageous; however, the principle is always to identify risks and take them into account in the final decision. "*
- *"* ***The principle of optimizing the capital structure:*** *This principle aims to ensure that corporate financial management pays due attention to the optimal composition of corporate capital, which should be reflected in strategic financial goals. The essence of optimizing the company's capital structure is to ensure adequate financial stability, reduce the cost of capital and achieve the required value of the company. "*

"In addition to the above basic principles, it is appropriate to respect some specific principles in financial planning : [21]

- ***Principle of long-term financial planning:*** *The essence of this principle is the fact that long-term (strategic) financial goals of the company should take precedence over short-term (tactical or operational) financial goals in the sense that operational goals (which* *are more specific and are essentially limited by the current situation). should support the gradual implementation of the intended main direction of the long-term development of the enterprise. However, when implementing this principle, it is always necessary to respect the different external environment of the company - it is clear that the possibility of implementing the principle is objectively better in developed and stabilized economies than in small or less developed economies. "*

- *"* ***Principle of hierarchical organization of financial objectives:*** *This principle is closely related to the previous principle and requires that both long-term financial objectives and short-term plans have only one (reasonably chosen) objective as the main (peak) objective for a given planning period. It is therefore important in corporate financial management that it is always clear which main goal is to be achieved in a given period and that other goals are set and evaluated primarily in terms of achieving the goal that is most important in a given planning period. The correct implementation of this principle unconditionally requires that the other objectives are compatible (consistent) with respect to the given main purpose and with each other. "*
- *"* ***The principle of real achievability of financial objectives: The*** *application of this principle presupposes the basis of financial planning based on the basic knowledge gained in the analytical phase of financial planning - especially the analysis of external and internal environment (including conclusions from financial analysis) and SWOT analysis. The importance of the principle stems in particular from the fact that the real achievability of the main corporate objectives has a significant incentive potential, which can be further supported by the incentive system. The second factor is that if a company (especially a company with publicly traded shares) achieves pre-declared goals, then this fact will be positively reflected in the external assessment of its credibility and rating. "*
- *“* ***The principle of periodic updating of corporate financial plans:*** *This principle is based primarily on the reality of corporate governance in relation to the changing environment - even the best compiled financial plan gradually (especially in the multi-year horizon) conflicts with corporate reality and the external situation; in this situation, of course, it is not possible to strictly insist on the target intentions and it is necessary to update the financial plans. For strategic financial plans, their annual update is recommended; for annual plans, a quarterly update is particularly appropriate. "*
- *"* ***The principle of substantial conformity of the structure and form of the main planning documents with the structure and form of company financial statements:*** *The*

essence of this principle is relatively simple and yet it is often possible in business practice to encounter cases of its violation - the structure, form and methods of compilation financial plans follow the structure, form and methods of internal economic reporting; only in this way is it possible to ensure the comparability of the statements and the possibility of monitoring the achievement of the planned objectives. "

- *" **The principle of simplicity and transparency of planned calculations:** This is a very practical principle that should lead business management to prefer such planning procedures and planning calculations, which have an uncomplicated basis and allow quick orientation. The essence of this problem lies mainly in the fact that the financial plans work not only financial experts, but also with managers often relatively low level of financial and economic knowledge. The use of complex and technically demanding procedures in this case could cause complications in the implementation of financial plans. "*
- *" **The principle of relative autonomy of the financial plan:** The plans of any company are seldom drawn up in such a way that they fully suit all interested groups - business owners, corporate management, individual business departments and employees. The external and internal environment of the company is undergoing various changes. All this forces the necessary major or minor changes in the company's financial plans. However, these should not be changes that discourage the company from meeting its strategic goals (provided, of course, that these goals have been properly formulated on the basis of qualified evidence). The principle of relative autonomy of the financial plan therefore - on the basis of the adopted strategic goals and conceptually conceived corporate financial policies - makes it possible to counter any attempts to dilute or abandon the set intentions. "*

The process of an organization's financial planner can be divided into several basic steps. In the first, it determines the planning method, the planned horizon (short-term, long-term), the size of the planned period (year, month, etc.). In the next step, it collects data, in this case from accounting and other economic plans, macroeconomic forecasts and other sources. The third step is to perform a financial analysis, ie to investigate and draw conclusions from the financial results of the company in previous years, including the identification of strengths and weaknesses and testing the informative value of the calculated indicators. The fourth step is to compile a financial plan and then continuously monitor the implementation of the plan. [22]

Concepts and problems associated with the preparation of a financial plan

Planning horizon [23]

A short-term plan in the form of a cash flow statement is usually prepared simultaneously in three planning horizons. In the framework of fortnightly to monthly planning horizon are monitored daily cash receipts and daily cash expenses. This horizon corresponds to the usual maturity of receivables and payables, which can be determined to a greater extent from already received and sent invoices. For a longer period, it does not make sense to monitor cash flows by individual days, as it is relatively difficult to estimate the exact daily flow in January, for example on 17 June. The plan is updated daily. In the framework of quarterly or biannual planning horizon are monitored weekly or monthly cash income and expenses. The plan is updated weekly resp. monthly. In the framework of the annual planning horizon are monitored monthly or quarterly cash inflows and outflows. The plan is updated monthly resp. quarterly.

Structure of income and expenditure [24]

For the purposes of this plan, we classify cash receipts in first place for certain and uncertain cash outflows to deferrable and neodložitelné . Basic theoretical proposition says that spending neodložitelné firm should bind to certain revenues and expenses deferrable on revenue uncertain. In practice, however, there is usually a significant disparity, non- deferred expenses tend to be higher than certain revenues. Therefore, such a breakdown of revenue and expenditure makes it possible to find weaknesses in short-term financial management. In addition to the breakdown of cash income by risk into certain and uncertain, we also monitor cash income by type of income (cash sales , debt collection, interest income) and by payers, ie persons who have paid or should make a business. Similarly, expenditure rules are outside the terms odložitelnosti (deferrable and neodložitelné) by type of expenditure (payment in cash, payment of obligations, installment loans, payment of wages, advances on tax).

Compensation for excess cash [25]

If a company finds that it has a short-term surplus of funds, investments in securities come into consideration in the first place . As this is only a short-term deposit, the company should invest in securities with high liquidity and low variability of expected returns (treasury bills). Another variant of short-term deposit of money are deposit products of banking institutions. Compared to investing in securities, depositing money in a bank is associated with lower expected returns, but also with lower risk and lower administrative costs. With the use of temporarily free funds, we can also meet in the form of pre-supply. However, frontloading is associated with the costs of storage, insurance and possibly obsolescence of property.

Compensation for lack of funds [26]

Ways of compensating for the lack of funds are either to obtain additional income or to reduce or defer expenditure. The company can achieve additional income mainly by selling its unnecessary assets. These are mainly short-term securities and shares that are not held for investment reasons. Similarly, we can proceed with the sale of surplus and unnecessary material. Revenue from the sale of products and goods can be accelerated by temporarily offering them on the market below the normal price. Receivables can be sold to a factor or collection company. We can sell real estate, machinery and equipment necessary for business to a leasing company, and then rent them under a so-called leaseback. Additional income can be obtained in the form of a bank loan. Today, public subsidies and subsidies play an increasingly smaller role, and above all the process of their provision does not count on days and mainly they are not intended for insolvent companies. The financial difficulties of small and medium-sized companies are usually solved by loans from partners, because the bargaining position of small and medium-sized companies on the capital and credit market is not strong and at the same time these loans are simply the fastest way. In the area of expenditure, the company should first review the planned expenditure and determine which expenditure is really necessary for the operation and which, on the contrary, can be deferred without jeopardizing the flow of operations. A reduction in the cash shortfall can also be achieved by negotiating a longer maturity of liabilities with suppliers based on the use of bills of exchange. Longer maturity of liabilities leads to a reduction in the trade deficit, and thus to an improvement in the company's cash flow. If the lack of funds cannot be compensated, the company becomes insolvent.

Determination of the minimum cash balance [27]

The minimum cash balance should be based on the structure of cash receipts and cash expenditures within the payment calendar. If the company has only certain revenues and all expenses can be predicted with certainty, then it does not have to hold any reserve funds. The stock of essential funds will be close to zero and the values of immediate and cash liquidity will be acceptable even at a low level. In the opposite case, when income can be considered on an uncertain, and it is possible occurrence of unanticipated expenses, the company must hold larger cash reserves, and therefore should maintain a higher value of these liquidity.

Financial planning in the public sector [28]

Financial planning itself, as a process, does not exist in the public sector. However, this does not mean that the individual elements of financial planning, as we know it in the private sector, do not occur in the public sector.

The main processes of financial management of organizations in the public sector include:

- budgeting;
- realization of personal expenses;
- financing;
- bookkeeping;
- financial control;
- controlling.

As can be seen from these six individual points, the concept of financial planning is replaced by the concept of budgeting. However, we must not forget the interconnectedness of individual processes, which implies that part of financial planning is hidden under each of these concepts. In the public sector, the function of the financial plan is taken over by the budget.

"A prerequisite for the successful functioning of the state and each level of territorial self-government, resp. also the subject of territorial self-government and an important financial instrument for securing tasks and activities at individual levels is the relevant public budget, in a broader context we can talk about the system of public budgets. In addition to the system of public budgets, other extra-budgetary monetary funds are often used, which are usually earmarked. At the state level, the state budget and possible state extra-budgetary special-purpose funds form the state financial system. Similarly, the budget and possible extra-budgetary funds form the financial system of the relevant entity of territorial self-government (in the Czech Republic, municipalities, or regions). Together they form the budget system. " [29]

The public budget is a policy tool. It is an important financial instrument for financing and ensuring the functions, needs and tasks of the state and each level of the entity of territorial self-government. The use of the public budget is mandatory by law. The public budget could also be characterized as a tool for financing purposefully programmed needs in the area of securing and securing various public goods. It goes without saying that it is not just a matter of programming the quantity, but also of the quality of public goods, for which financial resources will be available. In other words, these are goods of higher quality, for which the citizen is willing to pay extra. In this case, the so-called controlled concept of the expenditure budget is used. Thanks to this, it is not possible to suffice only with the annual budget, but this annual budget must be consistently linked to the budget forecast or outlook . [30] *" Detailed forecasts of the future costs of programs already approved should be prepared with the budget. This information plays an invaluable role in budgeting for the coming years by showing the size of the room for maneuver within the budget. It is also essential in the approval process to evaluate the future impact of laws, programs and other measures on future budgets. "*

Budget process [31]

"Financial management participates in the preparation of the draft of the relevant public budget, prepares its discussion and approval, ensures the management of the approved budget during the budget period and ensures control of budget implementation, both ongoing control during the budget period and follow-up control after the budget period. It is an entity involved in all stages of the budgetary process. " [32]

Phase 1 - Preparation of the budgeting process

Phase 2 - Implementation (creation) of the draft budget

Phase 3 - Approval of the draft budget

Phase 4 - Justification and approval of the proposal

Phase 5 - Creation of documents

Phase 6 - Breakdown of the approved budget

Phase 7 - Budget implementation

Phase 8 - Evaluation of the budget execution rate

Questions on the topic:

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