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ECONOMIC EFFICIENCY OF REAL SECTOR ENTITIES' CAPITAL IN TERMS OF THE BULGARIAN LEGISLATION

The object of this survey is the economic efficiency of the entities in the real sector of economy, while its subject is the economic efficiency of their capital in terms of the Bulgarian legislation. The purpose of this survey is, by applying the financial concept of capital and theoretical concepts of economic efficiency, to derive formulas and indicators measuring the economic efficiency of real sector entities' capital in terms of the Bulgarian legislation and to reveal the practical importance of knowing the economic efficiency of capital in terms of the applicable legislation.

JEL: M21

Objectives, survey thesis, importance and relevance

The said purpose sets the following *objectives:*

1. To clarify the terms 'equity' and 'borrowed capital' in terms of the financial concept of capital;

2. To present two theses on capital (financial and accounting), which ensures deeper understanding of capital; besides, the accounting thesis is covered by the national legislation;

3. To define the term 'economic efficiency' and consider the economic efficiency of real sector entities' capital in terms of the Bulgarian legislation on this basis;

4. To substantiate the necessity of thorough knowledge of the economic efficiency of said entities' capital by their financial management;

5. To identify the options (in general) to optimize the economic efficiency of real sector entities' capital; such options being stated in general as, in our opinion, they may be the subject of an individual survey of many pages.

According to the survey thesis, the economic efficiency of real sector entities' capital in terms of the national legislation as part of the economic efficiency of such entities represents the benefits/victims correlation.[1] In this case, benefits are the economic effects, while victims represent the entities' capital. Such efficiency should be monitored by the entities' financial management, which has to search for options to improve it. In the conditions of competition, such improvement is a prerequisite for the successful development of real sector entities. The monitoring of the economic efficiency of capital in terms of the national legislation is performed by using a number of indicators measured on the basis of certain economic effects (useful results) realized by entities and resources such as their capital. Useful

[1] Called 'management ability' by Prof. Dimitar Dobrev in his work *Principles of Individual Economy* published in 1941.

results (particular income and earnings) are covered by the Bulgarian legislation. It is within this context that we speak about economic efficiency of capital in terms of the national legislation.

The importance and relevance of the issues discussed result from the fact that real sector entities avail with capital and the matter in hand is the valuation of economic effects whose realization employ a unit of capital (BGN 1 or BGN 100). This issue is of permanent concern to the financial management of these entities as they have to monitor such values on monthly, quarterly, half-yearly and yearly basis.

Financial concept of capital. Bulgarian legislative provisions on capital

The Framework for the Preparation and Presentation of Financial Statements approved by the International Accounting Standards Board (IASB) in 1989 presents two concepts of capital – physical (it will not be discussed in this article) and financial. In particular, according to Paragraph 102 of the Framework, 'under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity'.

Under the financial concept of capital, the capital of an entity is money invested in such entity. As capital is synonymous with equity, invested money is the property of the entity's owners. Such money has been utilized by the entity and portion of its assets represents manners of equity spending.

The theory of corporate finance uses the term 'equity' as well as the term 'borrowed capital'. For example, one of the issues studied by this theory is financing, i.e. providing an entity with equity and borrowed capital. A number of other examples may be given. Therefore, we can speak about a financial thesis on capital – the equity-borrowed capital thesis.

Under the financial concept, borrowed capital is money invested in an entity by non-owners utilized by such entity and another portion of its assets represents manners of such capital spending. Non-owners are individuals and legal entities that have financial relations with an entity.

Accountancy includes the equity-payables thesis, where payables are forms of borrowed capital. In what sense does this thesis exist?

Financial accounting (a field of accountancy) is totality of regulated knowledge, including the balance sheets prepared by entities applying the National Financial Reporting Standards for Small and Medium-Sized Enterprises (NFRS for SMEs) and the statements of financial position prepared at the end of the reporting period by entities applying the International Accounting Standards (IAS). Both the balance sheet and the statement of financial position report equity and payables. In other words, financial accounting includes the equity-and-liabilities thesis. Therefore, it may be called accounting thesis.

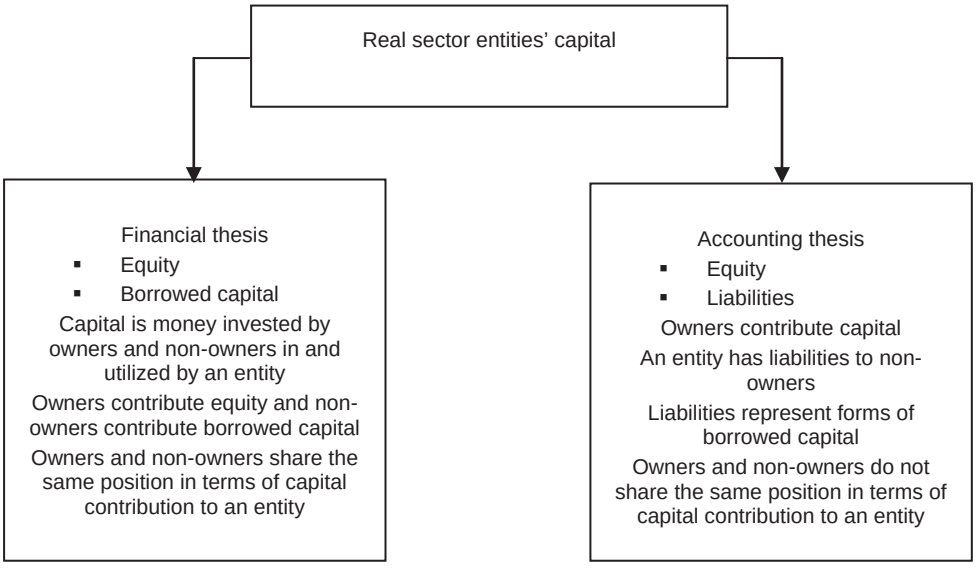
Under the financial thesis on capital, owners and non-owners share the same position as they both invest money used by an entity, i.e. they invest equity and borrowed capital.

Under the accounting thesis on capital, owners play the leading role as they invest money used by an entity (equity), while such entity has liabilities to non-owners on separate basis.

In his work *Systematic Course in Accountancy* published in 1945, Professor D. Dobrev states that 'In accountancy, we usually replace the terms 'property' and 'capital' with the synonymous 'asset' and 'liability'. 'Property' is called 'asset' as the activity of an entity shows itself through movement by the changes in the composition of property items. 'Capital' is also called 'liability' as it is just a total amount reflecting active property, i. e. a reference value on the economic functions of an entity. It should be noted that 'capital' is indentified with 'liability' only when it comes from an entity itself the capital of which includes both money invested by owners and money invested by third parties. In terms of private law and from owners' point of view, 'liability' (legal) usually represents debts to third parties (non-owners' capital) only.' Based on the statement made by Professor Dobrev, it is clear that an entity avails with capital, including equity as well as borrowed (non-owners') capital but, from owners' point of view, there exist equity available to an entity (but held by owners) and, separately, debts (liabilities) due by an entity to non-owners. In essence, Professor Dobrev presents two theses, i.e. the equity-and-borrowed capital thesis and the equity-payables thesis (see Scheme 1).

Scheme 1

Financial and accounting theses on real sector entities' capital



It should be noted that the term 'borrowed capital' does not exist in financial English but the terms 'debt capital' and 'loan capital' are used. In terms of connotation,

however, there is no difference between the term 'borrowed capital', on the one hand and the terms 'debt capital' and 'loan capital', on the other hand, as we speak about non-owners' capital in both cases.

Equity is covered by certain provisions of the Bulgarian legislation. In particular, *National Accounting Standard 1 Presentation of Financial Statements* provides for the balance sheet to be prepared by an entity applying NFRS for SMEs, which includes *Section A Equity*. An entity applying IAS reports equity in the statement of financial position as at the end of the reporting period in accordance with *IAS 1 Presentation of Financial Statements*.

The national legislation effective after 1989 has provided for a number of equity concepts. The first regulation concerning this issue is Decree No 276 of the Council of Ministers dated 30 December 1992, adopting the National Accounting Standards and the General Provisions thereto (effective as of 1 January 1993). These provisions define the term 'equity' as 'monetary equivalent of assets invested by the owners of an entity, i. e. an entity's net asset value, being the difference between the carrying amounts of an entity's real assets and liabilities'. Later, over the years, additional decrees adopting accounting standards and including general provisions defining 'equity' were passed.

At present, Decree No 46 of the Council of Ministers dated 21 March 2005, adopting NFRS for SMEs and General Provisions thereto, is effective. It came into force on 1 January 2005. In these provisions, the definition of 'equity' remains unchanged, i.e. 'equity' is defined as 'the value of the assets of an entity less all such entity's liabilities'.

Decree No 251 dated 17 October 2007, amending and supplementing the NFRS for SMEs adopted by Decree No 46 of the Council of Ministers and effective as of 1 January 2008, also applies at present date. The changes introduced by this Decree have had no effect on the equity concept, i.e. the definition of 'equity' as 'the value of the assets of an entity less all such entity's liabilities' has been preserved in the General Provisions.

Borrowed capital was covered by certain provisions of the Bulgarian legislation effective from 1991 till 1997 inclusive – the liabilities reported in the balance sheet provided for in the former Law on Accountancy, passed by the Grand National Assembly of Bulgaria on 3 January 1991 and effective as of 1 April 1991, included *Section B Borrowed Capital* where entities reported their payables. This section existed until 1997 inclusive. In 1998, the Law on Accountancy was amended and, as a result, the liabilities reported in the balance sheet no longer include such section. However, these liabilities report the payables, which are property forms of borrowed capital, just as before.

At present, *National Accounting Standard 1 Presentation of Financial Statements* provides for the balance sheet, which includes equity and liabilities. Besides, *Chapter Three* "*Assets, Equity, Liabilities, Income and Expenses*" of the Law on Accountancy treats issues concerning equity and liabilities (payables). It should be noted that many NFRS for SMEs applied by entities treat issues concerning equity and

payables. Such issues are provided for in a number of IAS, applied by a part of real sector entities, as well. These standards become effective in the member states of the European Union (EU) by virtue of relevant acts such as regulations.

In brief, at present, the Bulgarian legislative provisions on equity and forms of borrowed capital (payables) are the provisions of the Law on Accountancy, relevant decrees issued by the Bulgarian Government and certain regulations issued by the EU.

Economic efficiency of real sector entities' capital in terms of the Bulgarian legislation

As we know, there are number of concepts of economic efficiency (such as Pareto efficiency and other). This article discusses the issues concerning the economic efficiency of real sector entities' capital in terms of the Bulgarian legislation.

The economic efficiency of real sector entities incorporates resource efficiency (resources include an entity's capital, assets and personnel) and cost effectiveness, which actually represent two basic concepts of the economic efficiency of an entity in terms of the Bulgarian legislation and have specific aspects. One of the aspects of resource efficiency is the economic efficiency of an entity's capital (the other two aspects are the assets effectiveness and the personnel efficiency). Therefore, the economic efficiency of capital appears to be a component of the economic efficiency of an entity in terms of the national legislation.

We will discuss the economic efficiency of capital in terms of the Bulgarian legislation hereinafter (we are of the opinion that it is not necessary to deal with the two efficiency aspects mentioned above in this article).

The economic efficiency of capital is the economic effect (the useful result) whose realization typically employs capital amounting to BGN 1 or BGN 100. Respectively, efficiency is measured by using the ratio of the economic effect to the average availability of capital employed in its realization. Moreover, 'the economic efficiency of capital' may be defined as 'the average availability of capital employed in the realization of economic effect of BGN 1 or BGN 100'. In this case, efficiency is measured by using the ratio of the average availability of capital to the realized effect.

To ensure better clarity, we present the formulas used to measure the economic efficiency:

$$(1)\quad \frac{\text{Economic effect}}{\text{Average availability of capital employed in effect realization}}$$

$$(2)\quad \frac{\text{Economic effect}}{\text{Average availability of capital employed in effect realization}} \times 100$$

$$(3)\quad \frac{\text{Average availability of capital employed in economic effect realization}}{\text{Economic effect}}$$

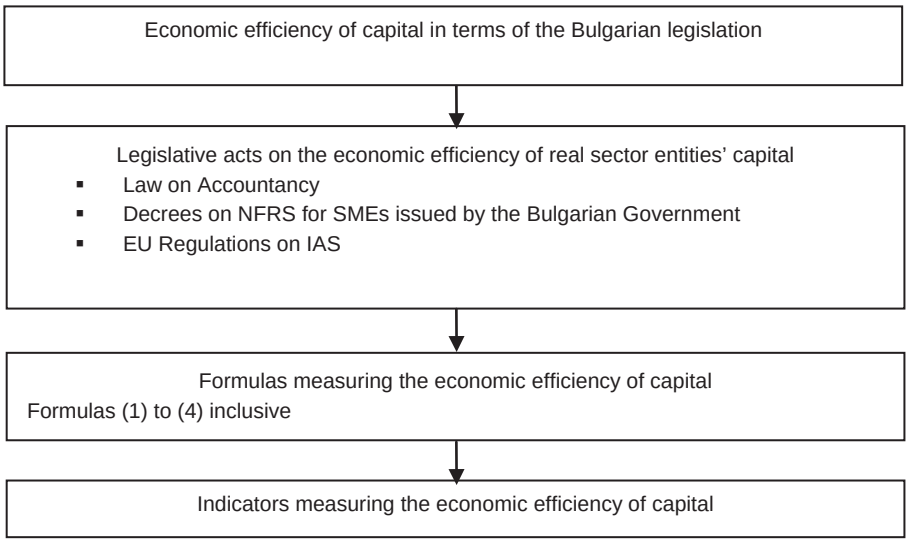
$$(4)\ \frac{\text{Average availability of capital employed in economic effect realization}}{\text{Economic effect}} \times 100$$

These are basic formulas, which become specific through the indicators measuring the economic efficiency of capital.

The economic efficiency of capital is based on the national legislation insofar as it is about useful results (economic effects) and resources such as capital provided for in the provisions of relevant legislative acts. These acts are the currently effective Law on Accountancy and decrees on NFRS for SMEs issued by the Bulgarian Government, including Decree No 46 of the Council of Ministers dated 21 March 2005 (effective as of 1 January 2005) and Decree No 251 dated 17 October 2007 (effective as of 1 January 2008), amending and supplementing the NFRS for SMEs adopted by Decree No 46 of the Council of Ministers dated 21 March 2005, and the EU Regulations on IAS (see Scheme 2).

Scheme 2

Economic efficiency of real sector entities' capital in terms of the Bulgarian legislation



Here are some indicators measuring the economic efficiency of capital where corporate income is the used economic effect:

$$(5)\ \text{Ratio of equity efficiency} = \frac{\text{Corporate income}}{\text{Average availability of equity}}$$

$$(6)\ \text{Ratio of borrowed capital efficiency} = \frac{\text{Corporate income}}{\text{Average availability of borrowed capital}}$$

$$(7)\quad \text{Ratio of total capital efficiency} = \frac{\text{Corporate income}}{\text{Average availability of total capital}}$$

$$(8)\quad \text{Reciprocal ratio of equity efficiency} = \frac{\text{Average availability of equity}}{\text{Corporate income}}$$

$$(9)\quad \text{Reciprocal ratio of borrowed capital efficiency} = \frac{\text{Average availability of borrowed capital}}{\text{Corporate income}}$$

$$(10)\quad \text{Reciprocal ratio of total capital efficiency} = \frac{\text{Average availability of total capital}}{\text{Corporate income}}$$

These formulas use the corporate income (the economic effect) realized over a particular period (a month, a quarter, etc.) and the average availability of relevant resources (equity, borrowed capital and total capital), which is the total of the resources at the beginning of the period, over which the corporate income is realized and the resources at the end of the same period, divided by 2:

$$\text{Average availability} = \frac{\text{(Resources at the beginning of the period + Resources at the end of the period)}}{\text{2 resources}}$$

It should be clarified that the total capital of an entity applying NFRS for SMEs (98% of real sector entities apply NFRS for SMEs, while the remaining 2% apply IAS) is the total of its equity, provisions and similar liabilities, payables and financing and deferred income, i. e.:

Total capital = Equity + Borrowed capital + Financing and deferred income

Borrowed capital = Provisions and similar liabilities + Payables

Total equity = Equity + Provisions and similar liabilities + Payables +
+ Financing and deferred income

Financing and deferred income represent capital not held by non-owners and usually occupies an insignificant relative share of the total capital of an entity. Moreover, many entities do not report them as they have no such capital at the end of the calendar year. As the total capital of an entity is mainly formed by equity and borrowed capital, when issues concerning such total capital are theoretically discussed, they refer to equity and borrowed capital.

Any increase in the values of indicators (5), (6) and (7) is a plus as it means that, on the average, resource of BGN 1 is employed in the realization of greater economic effect (higher corporate income). Any decrease in the values of indicators (8), (9) and (10) has favourable impact on an entity as it means fall in the average availability of resources employed in the realization of economic effect of BGN 1. This applies to the values of said indicators only if the effect (income) and resources (capital) are measured in BGN.

Further, we will present how the formulas measuring the values of indicators (5), (6) and (7) actually work by using data of an actually operating entity, and namely Contract City OOD, whose basic scope of activity includes research, design, building construction and trade in real properties. The Financial Statements of the company for 2011 and 2012 have been audited by a registered auditor whose opinion, which is stated in the reports prepared by such registered auditor, is that they give a true and fair value of the financial position of the company. These Financial Statements and the Reports thereto are published in the Commercial Register, which is freely accessed. These Financial Statements include the Balance Sheets and the Income Statements for the respective years.

The two tables below present the capital of the company as at the end of 2010, 2011 and 2012 and the income of the company for 2011 and 2012, which information is required to measure indicators (5), (6) and (7) for the said years:

Table 1

Capital of Contract City OOD as at the end of 2010, 2011 and 2012 (as reported in the Balance Sheets for 2011 and 2012), in thousands of BGN*

Years	Equity	Borrowed capital	Total capital
As at 31.12.2010 г.	2398	2658	5056
As at 31.12.2011 г.	2658	3112	5770
As at 31.12.2012 г.	2929	3056	5985

* Borrowed capital is the total of the amounts reported in Section B Provisions and Similar Liabilities and Section C Payables of the Liabilities included in the Balance Sheet. Total capital is the total of equity and borrowed capital. The Balance Sheet for 2011 also reports the capital as at the end of 2010.

Table 2

Income of Contract City OOD for 2011 and 2012 (as reported in the Income Statement for 2012), in thousands of BGN*

Years	Income
2011	4698
2012.	2740

*Income is the total of all proceeds of the company. The Income Statement for 2012 also reports the income for 2011.

It should be clarified that the data reported in the Balance Sheets as at the end of 2010 and 2011 are the data at the beginning of 2011 and 2012 respectively in accordance with Article 54 of the Law on Commerce, whish states that 'the opening balance for each year shall correspond to the closing balance for the preceding year' and one of the basic accounting principles provided for in Article 4 of the Law on Accountancy, and namely 'independence of the individual reporting periods and the value link between opening balance and closing balance: each reporting period should be treated, in accounting terms, in and of itself, independent of its

objective relation to the preceding and to the following reporting periods, while data in the financial statements at the beginning of the current reporting period must match the data at the end of the preceding reporting period.'

Measurement of indicators (5), (6) and (7) for 2011 and 2012 based on the said data:[2]

For 2011

$$\text{Ratio of equity efficiency} = \frac{\text{Corporate income}}{\text{Average availability of equity}} = \frac{4698}{(2398 + 2658) : 2} = 1.86$$

$$\text{Ratio of borrowed capital efficiency} = \frac{\text{Corporate income}}{\text{Average availability of borrowed capital}} = \frac{4698}{(2658 + 3112) : 2} = 1.62$$

$$\text{Ratio of total capital efficiency} = \frac{\text{Corporate income}}{\text{Average availability of total capital}} = \frac{4698}{(5056 + 5770) : 2} = 0.88$$

For 2011, average availability of equity of BGN 1 is employed in the realization of income of BGN 1.86, average availability of borrowed capital of BGN 1 is employed in the realization of income of BGN 1.62 and average availability of total capital of BGN 1 is employed in the realization of income of BGN 0.88.

For 2012

$$\text{Ratio of equity efficiency} = \frac{\text{Corporate income}}{\text{Average availability of equity}} = \frac{2740}{(2658 + 2929) : 2} = 0.98$$

$$\text{Ratio of borrowed capital efficiency} = \frac{\text{Corporate income}}{\text{Average availability of borrowed capital}} = \frac{2740}{(3112 + 3056) : 2} = 0.89$$

$$\text{Ratio of total capital efficiency} = \frac{\text{Corporate income}}{\text{Average availability of total capital}} = \frac{2740}{(5770 + 5985) : 2} = 0.47$$

For 2012, average availability of equity of BGN 1 is employed in the realization of income of BGN 0.98, average availability of borrowed capital of BGN 1 is employed in the realization of income of BGN 0.89 and average availability of total capital of BGN 1 is employed in the realization of income of BGN 0.47.

[2] Indicators (8), (9) and (10) are not measured for the purposes of compactness.

The values of indicators measuring the capital efficiency of Contract City OOD for 2011 are more favourable to the company compared to those for 2012 as average availability of relevant resource of BGN 1 is employed in the realization of greater economic effect over the same year compared to the economic effect for 2012, employing average availability of relevant resource of BGN 1. This study does not discuss the reasons for the decrease in the capital efficiency for 2012 compared to the preceding year.

Other indicators measuring capital efficiency are:

$$(11)\quad \text{Ratio of yearly equity efficiency} = \frac{\text{Corporate income}}{\text{Yearly equity}}$$

$$(12)\quad \text{Ratio of yearly borrowed capital efficiency} = \frac{\text{Corporate income}}{\text{Yearly borrowed capital}}$$

$$(13)\quad \text{Ratio of yearly capital efficiency} = \frac{\text{Corporate income}}{\text{Yearly capital}}$$

These indicators compare the economic effect, i. e. the corporate income, realized over a particular calendar year (1 January – 31 December) to the capital available to an entity throughout the same calendar year (from the beginning till the end), which means that such capital is used in the generation of corporate income throughout the year.

The yearly equity for a particular calendar year (e.g. 2013) is the difference between the equity at the beginning of the year (i.e. the capital at the end of the preceding 2012) and the portion of equity going out of an entity in 2013, which includes the portion of the profit for the preceding 2012 that is allocated to owners in the form of dividends as well as the portion of the subscribed capital returned to owners (decrease in subscribed capital) due to a decision on economic operations shrinking made by the owners, for example. There are also other options as to the equity going out of an entity in 2013.

If on the first business day of a particular calendar year (e.g. 2013) capital, representing portion of equity that will be available to an entity till 31 December 2013, goes into an entity, such capital forms portion of the yearly equity for 2013 and, therefore, it should be included in the measurement of the latter.

The yearly equity for a particular calendar year (e.g. 2013) is a constant value.

The yearly borrowed capital for a particular calendar year (e.g. 2013) is the difference between the borrowed capital at the beginning of the year (i.e. the borrowed capital as at the end of the preceding 2012) and the portion of borrowed capital going out of an entity in 2013 due to required liabilities settlement.

If on the first business day of a particular calendar year (e.g. 2013) capital, representing portion of borrowed capital that will be available to an entity till 31

December 2013, goes into an entity, such capital form portion of the yearly borrowed capital for 2013 and, therefore, it should be included in the measurement of the latter.

The yearly borrowed capital for a particular calendar year (e.g. 2013) is a constant value.

The yearly capital for a particular calendar year (e.g. 2013) is the total of the yearly equity for 2013, the yearly borrowed capital for 2013 and the portion of financing and deferred income available to an entity throughout 2013.

The yearly capital for a particular calendar year (e.g. 2013) is a constant value.

The optimization of the economic efficiency of real sector entities' capital represents increase in the values of indicators measuring such efficiency when a relevant formula uses the economic effect as numerator and the average availability of capital employed in such effect realization as denominator.

The optimization of the economic efficiency of real sector entities' capital also represents decrease in the values of indicators measuring such efficiency when a relevant formula uses the economic effect as denominator and the average availability of capital employed in such effect realization as numerator.

Hereinafter, we will focus on the optimization of the efficiency of real sector entities' capital when the economic effect is the total corporate income.

Optimization of capital efficiency is present when the rate of increase in corporate income is higher than the rate of increase in capital values or there is, over a particular period, increase in corporate income and preservation of capital values unchanged (compared to a preceding period).

Increase in the net income from sales of finished products, goods and services results in increase in corporate income, which is a prerequisite for achieving higher economic efficiency of real sector entities' capital. Therefore, we will discuss some issues concerning such increase in net income below.

One option to increase capital efficiency is expanding the markets where entities offer their finished products, goods and services as well as introducing new finished products, goods and services to such markets. This result in increased net sales income, i.e. increased total income. In addition, as mentioned, this may result in higher economic efficiency of capital.

Another option to increase net sales income by Bulgarian entities is penetrating the markets in the EU member states and other countries while entities, which have already entered these markets, may seek options to increase sales volume and net sales income respectively.

The marketing departments of real sector entities play the key role in the realization of these options.

Entities producing finished products may increase production volume and net sales income respectively through purchase of modern equipment and technologies with own funds as well as externally received funds. Externally received funds are proceeds from sale of new shares and obligations (applicable to joint-stock

companies), contributions for acquisition of new shares (applicable to entities of other legal forms) and credits granted by commercial. Besides, entities may be granted funds under EU operational programmes. Externally received funds represent forms of capital, i.e. equity and borrowed capital report increase. In this case, a production entity reports higher economic efficiency of its capital if the increase in the net income from sales of finished products results in higher rate of increase in total income compared to the rate of increase in capital.

Entities may increase production and net income from sales of finished products through shortening production cycles (a production cycle is the calendar period as of production process initiation till production process completion, including the duration of all related operations from putting particular quantity of materials into production till creation of finished products from these materials and taking them to finished products warehouse) instead of purchasing new equipment and technologies. Shortening may be also realized through applying relevant measures of organizational nature (rationalization of machinery location, improvement of work at warehousing premises, optimization of transport within and among workshops, etc.). The optimization of wages and salaries organization (e.g. proceeding from straight piecework system to piecework progressive system or piecework-bonus system) results in production cycle shortening as well. Such shortening makes it possible to produce greater volume of finished products for a particular period (e.g. three months), which is a prerequisite for increased net income from sales of finished products.

Other options to increase net income from sales of finished products is optimizing production schedules and deferred payment offers to customers (this is a common practice in the relations with commercial entities) by producers.

Also, an entity' products promotion policy affects the increase in its net income from sales of finished products.

The improvement and expansion of the set of facilities have material impact on the increase in net income from sales of goods and services realized by commercial and service entities. Such improvement and expansion may be achieved as mentioned above (applicable to production entities). As to these entities, advertising and improving stimulation through benefits and deferred payment offers to customers are also options to increase net income from sales of goods and services. There are a number of other options to increase net income from sales of goods and services, which is a prerequisite for increase in commercial and services entities' total income, which enables increasing the economic efficiency of such entities' capital.

The economic efficiency of capital should be analyzed by entities' competent experts who are to specify, if necessary, particular measures for its optimization in their reports. Moreover, it is proper to plan the values of indicators measuring capital efficiency for the relevant period, compare actual values to planned values following the end of such period and, if there is negative deviation, seek the related reasons to avoid such negative event in the future.

In conclusion, deep knowledge of the economic efficiency of real sector entities' capital in terms of the Bulgarian legislation is a prerequisite for the successful functioning of these entities. Optimization of the economic efficiency of capital gained by entities is essential to the favourable development of entities in the conditions of market economy.

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24.10.2013