STRATEGIC RISK MANAGEMENT

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Summary: The strategic management of commercial companies in times of crisis places a strong emphasis on the management and control of the risk. There is no business activity in the world that is not associated with various types of risk. In a highly competitive and turbulent environment, the clear linking of the business strategy of the firm and its risk management makes it possible to identify and manage the risk of the surrounding environment and the on-going movements within it. Strategic risk management creates a protection value that ensures a sustainable internal environment. This is a continuous process that is embedded in the strategy.

Key words: Strategic risk management, risk levels, financing.
JEL: G21, G30.

Effective risk management is the cornerstone of the most successful companies. In contemporary high-risk business environment, managers would hardly have the confidence that their plans and expectations would be fulfilled. In commerce, as well as in the banking sector, the financial risk carries the greatest burden. The main issue with this type of risk is the attraction of funds. The structure of funding is important for all businesses regardless of their activity. For retail chains, the use of borrowed capital is "the necessary evil", without which commerce cannot function. Figure 1 shows the evolution of trade credit risk exposures from 2008 to 2015. According to the annual financial statements of the BNB (Bulgarian National Bank) for the period 2008-2015, the allocation of credit liabilities by financial sector shows that trade enjoys the highest confidence from the side of the banking sector. Throughout the whole researched period, trade remained the most popular sector in the country to be financed with loans.

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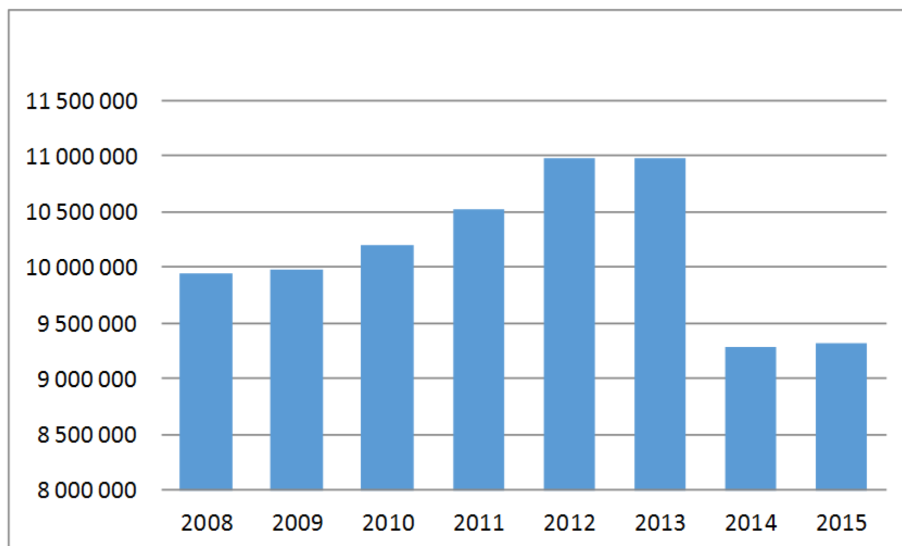
Figure 1. **Credit liabilities in the sector of trade**



Source: Annual financial reports of BNB for the period from 2008 to 2015.

Financial risk is assessed by analysing three main pillars of financial indicators. The first pillar includes equity as an indicator of the sustainability of the business firm. Maintaining stable levels of capital adequacy allows the commercial organization to maintain its liquidity in the long and short term.

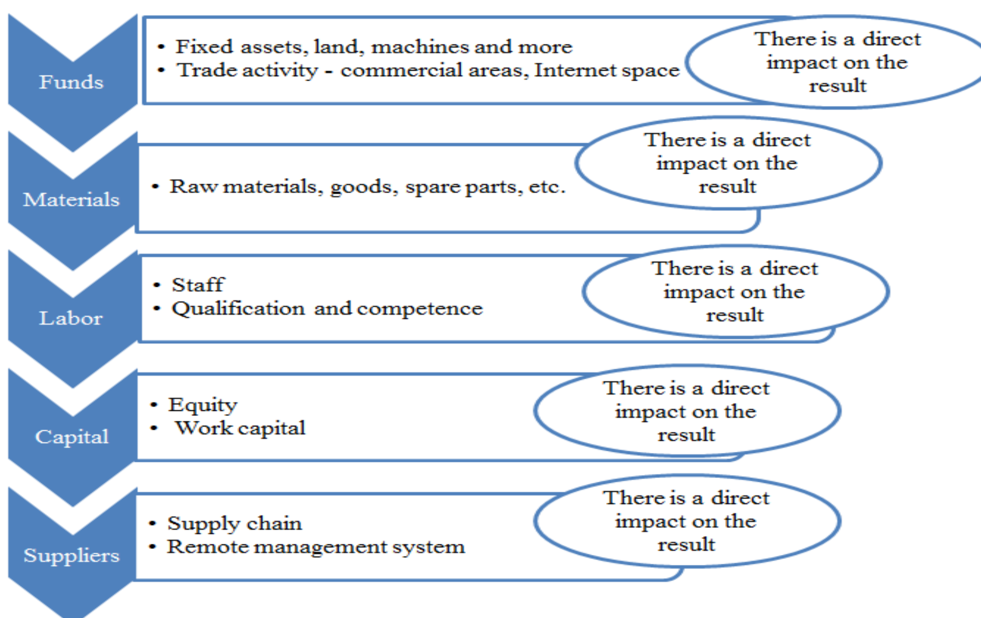
The financial leverage is the indicator for the impact of the borrowed capital, i.e. it takes into account the ratio of the amount of the balance sheet profit and the interest payments to the profit margin. The higher this value, the greater is the financial risk. These higher levels of financial risk are predetermined by the use of external financing and payments of interest and principle. Financial Debt is the first pillar of the financial structure and includes long-term bank loans, subordinated lease obligations, other long-term liabilities, and short-term bank loans.

The second pillar subjected to analysis is related to yield. The main focus here is on revenue growth and dynamics (the effect of increased volumes, price levels, exchange rate fluctuations, geographical expansion, new investments and market niches/product segments). This pillar discusses changes in operating results and changes in production costs.

The third pillar determines the ability of the commercial organization to meet its payments, or in other words, the formation of "current cash flow". Cash flows express the dynamics of the trading company and provide coverage of investment risks.

Most businesses experience seasonal fluctuations that affect revenue. In this case, the revenue may often turn out to be less than fixed costs. This is why the allocation of a reserve fund to ensure the continuity of the business processes becomes a necessity. Trading companies usually have high levels of fixed costs, which predetermines their dependence on a number of dynamic factors - funding, labour, capital, etc.

Figure 2. **Basic dependencies of commercial companies**



Business environment dynamics puts a number of challenges before trading companies. Optimizing business processes requires a balance to be struck between the different dependencies in which a trading company operates.

Funding dependency - the emphasis is placed on the facilities, equipment, warehouse space, storage capacity, and the dedicated channels for their realization. The trading company is directly dependent on the fund, its exploitation and technical maintenance represent a major part of the costs of the company.

Material intensity - the material supply of the company is related to the supply of raw materials and commodities. The cost of materials is dependent on a number of external factors, which determines their sensitivity even to weak fluctuations.

Labour intensity. Under the conditions of equal quality and price levels, it is the staff that adds value. Assuming that a trading company is a living organism, the staff is the brain of that organism.

Capital intensity - the choice as to what extent the commercial chain is to operate with its **own and loan capital**. The loan capital is the engine of the business, but within reasonable limits, as if the critical breakeven point is passed, the trading company bears an enormous risk of becoming insolvent or even bankrupt. By increasing this value, the financial risk grows too. In order to increase the profit by BGN 1, the actual profit must actually be slightly more than BGN 1. The size of this markup depends on the volume external financing and the associated interest payments. In case of inaccurate calculation, interest due may be several times higher than the operating profit. The key issue for a firm is to ensure a net cash flow to its core business activity in order to secure the repayment of the loan and interest on it in a timely manner. This is why the cash flow forecast rather than the Profit and Loss account (Income statement) is of paramount importance. Cash flow problems can occur when there is no revenue due to lack of sales, i.e. when no payments are received for goods and services sold.

Table 1. **Risk levels**

Level of production risk	**Business type**	**Financial risk level**	
		High	**Low**
		By actively attracting external financing	**Predominantly own financing**
High	Fund dependent		
Average	Labour intensive		
Low	Matreial intensive		

Table 1 shows the different levels of financial risk. The situations which, all other conditions being the same, would not exceed the acceptable risk levels, are shaded in grey. The table illustrates why to create a fund-dependent business with an active attraction of external financing is too risky, and to develop a material-dependent business with its own funds is irrational. Very often, commercial firms are fund-dependent, which is done by the attraction of external investors. Finding the optimal point of use of loan capital is the starting point for the future development of the commercial company. Strategic management should be focused on streamlining cash

flows, as well as on creating a buffer to ensure firm stability in case of decline in the earnings.

In the conditional division of the period of economic turmoil in three stages (2008-2010, 2011 - 2013 and 2013 - 2015), the following conclusion can be drawn: During the first period under review, the lending in the sector of commerce in absolute value increased. This increase is due to the utilization of agreed credit exposures, without granting new credit financing, i.e. the period of the so called standstill of the banking market. In the first period, namely 2008 - 2011, the retail chains depicted a growth of their revenues by nearly BGN 160 million and out of this figure, the revenue of Lidl was deducted as the chain started its activity in 2010. This increase is mainly due to four retail chains - Kaufland, Carrefour, Billa and Fantastico. After the introduction of Lidl into the country, the influence of the "discounters or discount shops" is becoming more and more pronounced. The second period - 2011 - 2013 is characterized by slow growth of the business, but the profits diminish and even convert into negative values. Generally, the grocery business of the chains with the greatest market share grew by 1% according to the BNB data these chains make a total turnover amounting to over BGN 3.895 billion. According to data presented by te analysis and consulting company ICAP the total volume of fast moving goods (FMCG) trade is BGN 10.3 billion in 2013, which means that the top ten make 38% of sales. Consumption remains stable due to two main factors: expanding the retail chains of large chains at the expense of small shops and increasing the market share of one chain at the expense of others. Based on data from GfK[2] data for 2013, modern commerce accounts for 66% of household consumption. In 2014, the retail and commerce sectors began to accelerate their slow growth, due to the fact that three retail chains in the country are experiencing serious difficulties. The first one is Carrefour - the negative financial results of the trading company are causing the suspension or delay of the payments to the suppliers, the liabilities to them exceed BGN 23 million. Another chain that is experiencing serious difficulties is Piccadilly. The attempt for saving the company is through the received bank loan amounting to more than BGN 20 million with the purpose of providing bank guarantees of up to BGN 4 million and credit in the form of an overdraft facility of up to BGN 20 million for the payment of obligations to suppliers. The third trading chain that is experiencing serious financial difficulties is Penny Market. The chain has 49 stores in the country, but the huge difference in expected cash receipts with the actual ones forces it to leave the Bulgarian market at the end of 2015. Penny Market releases a market share of BGN 200 million in

[2] http://www.gfk.com/bg/about-gfk/gfk-in-your-country/

revenue and 50 stores. Unlike Piccadilly and Carrefour, Penny Market does not leave behind obligations and lawsuits. The incorrect assessment of own opportunities, wrong expectations, mismanagement of financial risk, caused two retail chains to close down within two years, and a rescue plan to be applied to another one. The withdrawal of these two chains from the Bulgarian market provides better starting points for the entry of a new trading chain as well as a new market potential for the existing ones.

Dependent on suppliers – the events with the international chain Carrefour in Bulgaria have raised the issue of the concept of the supply chain management. Its incorrect management led to a decline in consumer confidence followed by a surge of the consumer demand. The Supply Chain Management is a concept for efficient management of raw material procurement processes, product and service creation, tracking them in the distribution chain, and delivering to the end user. (Novakova, G.,Modern Supply Chain Management, SU, Sofia 2014, p. 5) The Supply Chain Management concept is a continuation of the management methodologies that have arisen in the process of adapting modern information technologies to the practice of the developing business. The development of modern state-of-the-art technologies enables new governance and a high degree of integration between different business systems. The management of the logistics system has a leading role whereas the main goal of strategic risk management is to ensure high reliability of its operation. The two main groups of factors that determine the effectiveness of the logistic systems are: Diversity and purposefulness of the management impacts on material, information and financial flows; Comprehensive logistics infrastructure, i.e. a service and traffic flow management system. For business companies to be well prepared and to react quickly and efficiently to the changing market, so-called modelling technology is used to create working and "live" models of the overall supply chain. (Novakova, G.,Modern Supply Chain Management, SU, Sofia 2014, p. 47) This model helps to clarify what the current supply chain structure is and what would happen if we try this. The platform, on which basis the risks to the supply chain will be analysed, should be built on the foundation of a number of modelling techniques, including network and inventory optimization; Improving transport flows; Simulations supplemented by benchmark data for alternative options as well as risk indicators that are not present.

Recommendations are necessary on how to fund the retail chain in order to optimize cash flow and their good management. It concerns also the business chains are business that relies on the Fund (the material base), labour, materials:

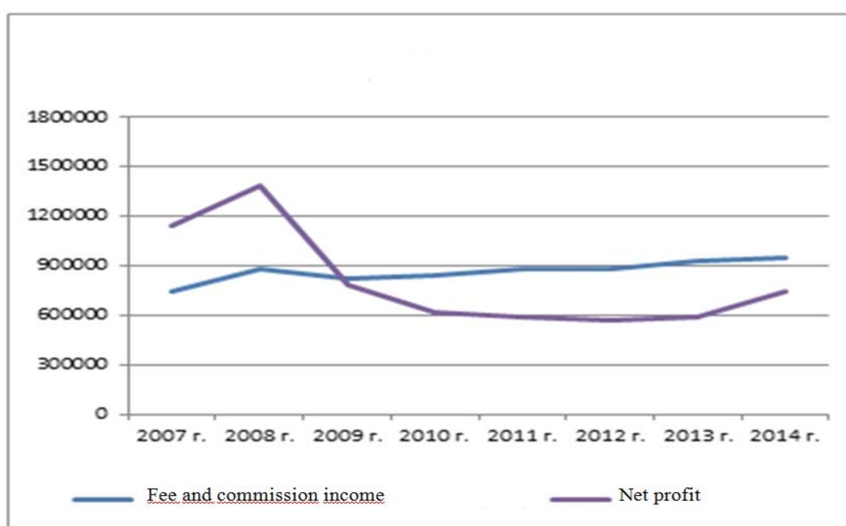
- Funds or facilities/ material base – Funding mostly with own funds – Cash flow violations are permissible if the owners are willing to lose the funds invested. Funding with borrowed funds –According to this option, it is necessary to maintain net cash flows, i.e. high profits and strict credit policy, ensuring the projected growth of receipts.
- Labour or human capital – Funding mostly with own funds – This type of financing runs the risk of shortage of funds and their lack should be covered by the owners. A firm that is unable to cover its obligations to the staff is threatened by a very rapid depletion of money resources. Financing with loan capital – such a funding is only allowed for short-term shocks, as for an example are the delayed payments by a debtor. The strategic management of the firm requires employees to "earn their salary" and to generate it from the realization of the output, i.e. the salary is incorporated in the price of the products.
- The materials – Funding mostly with own funds – an ineffective option for the organization of the company. The investment in assets will lead to the accumulation of inefficient assets, i.e. blocking equity, without using the option of turning it over in circulation. Financing with significant external financing. It is necessary to clarify that an effective credit policy must be in place to ensure timely payment of funds and strict and timely repayment of the credit obligations.
- Distribution – when selecting a distribution channel, sensitivity must be established as a result of scenario development, adaptation to variables and testing the consequences.

The strategic management has also imposed major changes in the banking sector. Granting loans "at any means" has remained in the past, with the clarification that banks have paid a high price and continue to suffer from and experience the consequences of this policy of them. In 2008, the process of harmonization in the area of risk management was significantly accelerated. The bank policy aimed at the management of the main bank risk – the credit risk. A significant attention was paid to the assessment and management of credit risk as the most significant for the bank. The overall Bank Risk Management Strategy for the period 2008-2010 was implemented. In the Credit Policy there were implemented a number of reforms with the purpose of a better functioning. A part of the indicators and the workflows were individualized with the purpose of their more precise analysis.

Internal control system - until the crisis, much of the rules and actions were simply written down, some of them existed, others not. This is

the main reason for the significant growth of the bad loans of the banking institutions. The profits that the banks realized would not be at the same amount, but the volume of loans classified as "loss" would be considerably less. In Bulgaria, commercial banks make profits from interest, fees, and commissions on the granted loans, which is the reason why they disburse a huge amount of money in various forms. It is precisely the pursuit of high profitability and profit, which has led to the destruction of a number of businesses.

Figure 3. **Fee and commission income and net profit of the banking system**



Source - BNB

The introduction and enforcement of the bank's internal risk rating classifications in the context of financial and economic crisis, the regulatory actions taken by the G-10 have had a strong positive impact on the country's credit system. Basel I is a round of debates between bankers around the world, and in 1988 the Basel Committee in Basel, Switzerland, published a series of minimum capital requirements for banks. The Basel I concept has achieved excellently its purpose, but over the time it has come to the fore the need to find another "better solution" to create one measure for all .[3] In the new economic environment, there was a need for asset aggregation and the application of uniform risk weights (PD rating) for risk assessment. The

[3] Regarding this matter for details see: Milanova, E. Preparation and reflection of the new capital agreement (Basel II) on the banking system of Bulgaria

imprecise risk diversification has led to inaccurate assessments of credit risk assessment. All this imposed the necessity of development of an Advanced New Agreement (Basel II – 1992). The new Basel Accord was designed to develop the methods and techniques by which banks will have the opportunity to manage risk more easily and effectively.

The final version of the Basel Agreement (Basel II) made a serious impact on the banking business and was approved in June 2004[4] by the Governors of the Central Bank and the G10 supervisory authorities. In Bulgaria, the new capital framework was adopted in 2006, but came into force with the accession of Bulgaria to the EU on 1 January 2007.

Market risk management is based on regular monitoring and risk measurement of bank portfolio positions and integrated management of the balance sheet structure. In the banking business credit losses are a constant phenomenon - there are always borrowers who cannot meet their obligations.

Under Basel I, banks are required to maintain a certain level of capital to cover credit and market risk. The size of the credit portfolio of the commercial bank is limited by the amount of equity. The basic disadvantage of Basel I (Figure 4) is the lack of diversification of the different levels of risk as well as the unaccounted level of the risk.

Figure 4. **Basel I**

Option 1		Option 1	
Risk	Capital	Risk	Capital
Credit for a company with a rating AAA- EUR 100 Bank guarantee -50 Price - 3%	RWA*: EUR 60 Capital: EUR 5	Credit for company With a rating B+ EUR 100 Bank guarantee -50 Price - 3%	RWA*: EUR 60 Capital: EUR 5
ROE** = 6,57 %		ROE** = 28,34 %	

* RWA - weighted average amount of the risk assets;
**ROE - return on equity

Actual losses vary from year to year, depending on the cases of default, even assuming that the overall quality of the portfolio is constant over

[4] International Convergence of Capital Measurement and Capital Standards, A Revised Framework

time. Non-repayment of single loans does not entail major losses to the bank if they can be offset by reserves booked against the expected losses on credit operations[5]. The main problem of the entire banking system in the country was that credit exposures were not valued according to market requirements. Concentrating too many risks in several market segments can lead to significant asset losses in the loan portfolio.

The deficiencies of Basel I have created a need for a new way of evaluating. The changes that have occurred in Basel II build on the previous agreement. The focus is on calculating the expected and unexpected loss. The capital requirements depend on the borrower's creditworthiness. Basel II introduces a new PD model that shows the probability of default. Based on this model, the bank institution calculates a percentage of how much of the exposure the bank may lose if the credit exposure is not extinguished. The loss depends on the type and value of the collateral, as well as on the expected revenues from its liquidation.

The changes made it possible to achieve diversification according to the different risk levels, forming a lower risk portfolio, diversifying the different risk levels, as well as the reported risk levels.

Figure 5. **Basel II**

Option 1

Risk | Capital

Credit for a company with a rating AAA- EUR 100

Bank guarantee -50

Price - 3%

RWA*: EUR 37

Capital: EUR 3

RAROC = 9 %

Option 1

Risk | Capital

Credit for company With a rating B+ EUR 100

Bank guarantee -50

Price - 3%

RWA*: EUR 200

Capital: EUR 9

RAROC= 7 %

*RAROC - adjusted based on the risk from return on equity

Basel III was developed in response to the financial crisis and it does not replace Basel I and Basel II, but focuses on various issues that are mainly related to the risks of insolvency and the correct assessment of the reliability

[5] Requirements under BNB Ordinance 8

of the borrower. Following the onset of the global financial crisis, the banking system is characterized by the following weaknesses:

● *A high amount of borrowed capital* due to the high indebtedness in the banking and financial system, as well as insufficient qualitative own capital that generates losses;

● *Too fast and large credit growth* based on highly underestimated standards for managing inherent risk and pricing for liquidity and credit risk based on lower prices and prudent levels;

● *Insufficient liquidity buffers* and too aggressive maturity transformation, both directly and indirectly (quasi money in the banking system);

● *The systemic risk* at extremely high levels puts the whole system under shocks and inadequate supervision does not allow the problem to be mitigated.

One of the basic requirements of the Basel Committee is to determine the capital requirements and, in particular, the adequacy of Tier 1 capital (basic premium capital plus high-quality financial instruments), and that the capital adequacy ratio should be no less than 4 %[6]. It is the capital the one that provides the bank's credibility.

Main goal – the loss calculated in that way must be covered by adequate levels of risk provisions. The unexpected loss must be covered by capital. Exceeding the expected loss over the specific provisions leads to a decrease of the established level of the Bank's own capital. Regardless of the segment, each client with exposure has to be assessed through an approved rating / scoring of his creditworthiness, i.e. he/she must have a risk parameter - probability of non-execution: amount and type of the credit limit; Letter of Guarantee or Letter of Credit; Type of collateral provided; Other credit liabilities. Customer rating is not only a basis for decision-making on the loan in terms of risk but also for: credit terms - amount, interest rate; Control of credit risk; Credit risk trading - securitization; Price of risk - impairment, provisions; Calculation of the required capital in the Basel II context (capital requirements, capital adequacy); Portfolio analysis – credit portfolio management.

PD rating may vary between 1 and 10 (there are different rating scales, but I will look at the most common), i.e. the higher the numeric indicator, the higher the potential risk of default. The goal is to determine the one-year probability of default for each individual client and creating a quantitate expression of the default by calculating the "expected loss". Last but not least,

[6] Under Basel III, the capital adequacy ratio shall rise to 6% by 2015

the credit portfolio is managed in a manner consistent with the specific risks. Table 2 presents a description of the rating levels.

Table 2. **Classification of the PD rating levels**

Rating level	Clasification	Clarification
From 1+ to 6-	Rating levels for customers with very good to almost acceptable ratings	Customers with the potential to repay credit exposure without serious arrears
From 7 + to 7 -	Rating levels for business customers with poor rating	Clients with such ratings have high risk values and should be monitored due to the need for reorganization
From 8 + to 8	Need for reorganization (renegotiation or restructuring)	For these borrowers, specific provisions are not yet set aside to cover the risk of loss on loans for reorganization and collection of funds.
From 8 - to 10	Clients in default	Borrowers that require extra attention
*** Rating 8-**	Non-performance in excess of 90 days	Borrowers without booked provisions to cover the risk of loss on loans. The aim is the business to function.
*** Rating 9**	Amortized assets	These include companies for which specific provisions and allowances are foreseen
*** Rating 10**	Loans that are subject to forced collection and full provisioning	This includes loans that require full provisioning, collateralisation and write-off of the exposure

Creating an effective mechanism for the normal functioning of the lending process implies a complete link between the bank's accounting and banking policy. The goal is an improvement of the loan portfolio, better classification and customer selection. The effects of the undertaken actions have a very positive impact, as a measure of this is the decrease in the amount of bad loans. By the introduction, and especially through the use of this system, the banking system has become a business partner, because the granting of an "incorrect" credit can lead to bankruptcy of the borrowing company. The resulting financial and economic crisis has forced the introduction of many new operating rules. The risk assessment of each potential borrower has become of paramount importance. In order to better manage the bank portfolio, additional units were created with the main purpose of specialization and more expert management of credit exposures.

Stress testing of the banking system In the process of risk management, stress tests are an important tool that has been used for years by banks as part of the internal risk management process. Thus, the Supervisory Authorities assess the resilience of banks to the financial system against possible shocks. This type of test assesses the adverse and unexpected consequences associated with a number of different types of risk by providing

information on the capital required to bear the losses if the suspected shocks occur. Usually, stress tests provide a series of hypotheses and "in case of" scenarios of varying degrees of severity. The aim and the provision of information are related to the policy for assessing the sustainability of the banking system in the EU, related to potentially unfavorable development. An assessment is made of the banks included in the test as for their ability to absorb possible shocks related to credit and market risk as well as sovereign risk.

In 2009, the test was conducted in 26 leading banks in Europe, in 2010 its scope was extended to 91 banks, accounting for 50% of the banking sector in terms of total assets. The stress tests performed include the following number of parameters. The adequacy of Tier 1 capital is calculated. Calculations are then carried out by making assumptions about a shock in the sovereign debt market. The test focuses on credit and market risk, including exposures to sovereign debt at European level. Its main focus is on capital adequacy, but liquidity risks are not directly tested.

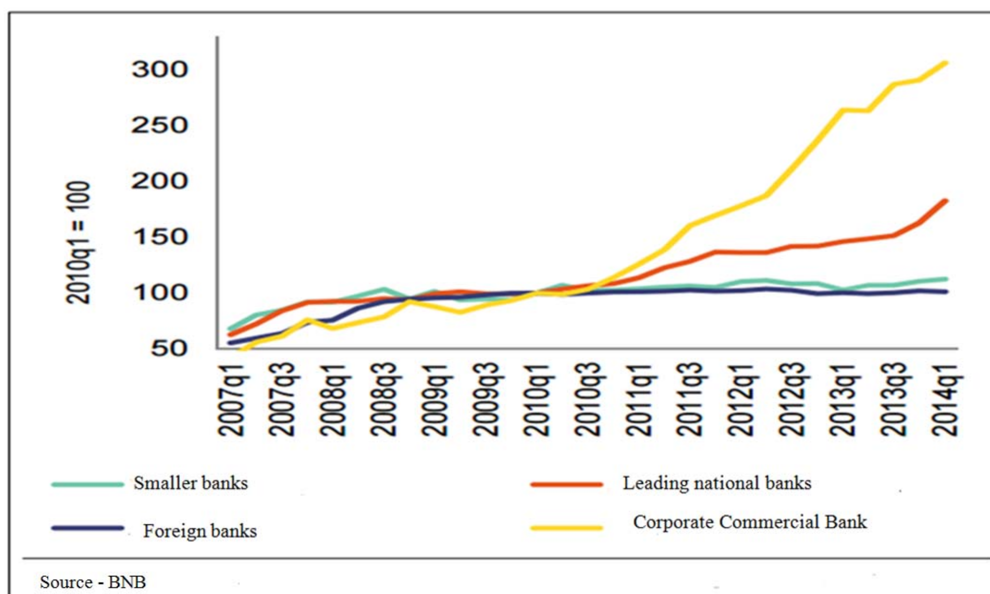
The stress test is considered to be successful and acceptable if the Capital Adequacy Indicator of Tier 1 is 6%, which is used to determine the potential need for recapitalization, while the according to the Minimum Capital Requirement Directive the value of the indicator is 4%.

The banks in the Eurozone have increased their bad credit provisions by tens of billions of euros, hoping to reduce the risk of stress test failure. Despite of that a part of bad credit exposures remains uncovered. In 2014, in order to pass the stress test, the financial institutions of the Old Continent should not have bad (non-performing) loans exceeding 8% of the total amount of loans. Then 24 banks failed the test with a total capital deficit of 24.6 billion euros. With regards to the banking system in Bulgaria, the allocated provisions cover only 1/3rd of the amount of the bad loans.

Overall, as a result of the crisis, the new financing in the construction and tourism business was totally discontinued. Revival of lending, we observe only at the end of 2011 and an exception for the country's market is made only by CCB *(CCB is not part of the sample, although it was the fourth largest in the country. In Figure 4 it is presented for informative purposes only. Its development is not in line with normal market developments for a commercial bank, as in a time of severely limited lending CCB has shown tremendous growth in lending.*

The enterprise-level data confirms the macroeconomic and financial risks associated with high corporate debt. The review of debt leverage and enterprise profitability, it is noted that a significant proportion of companies operate at a very high debt-to-capital ratio and low profitability, measured by EBITDA. This means that debt financing is not being used to the benefit of

Figure 4. **Change in lending**



Source - BNB

these companies and that a significant part of the funding is concentrated in the most unprofitable companies. It was precisely that the mistake of the banking sector where the incorrect assessment of the risk and the economic situation became a prerequisite for granting non-repayable credit exposures.

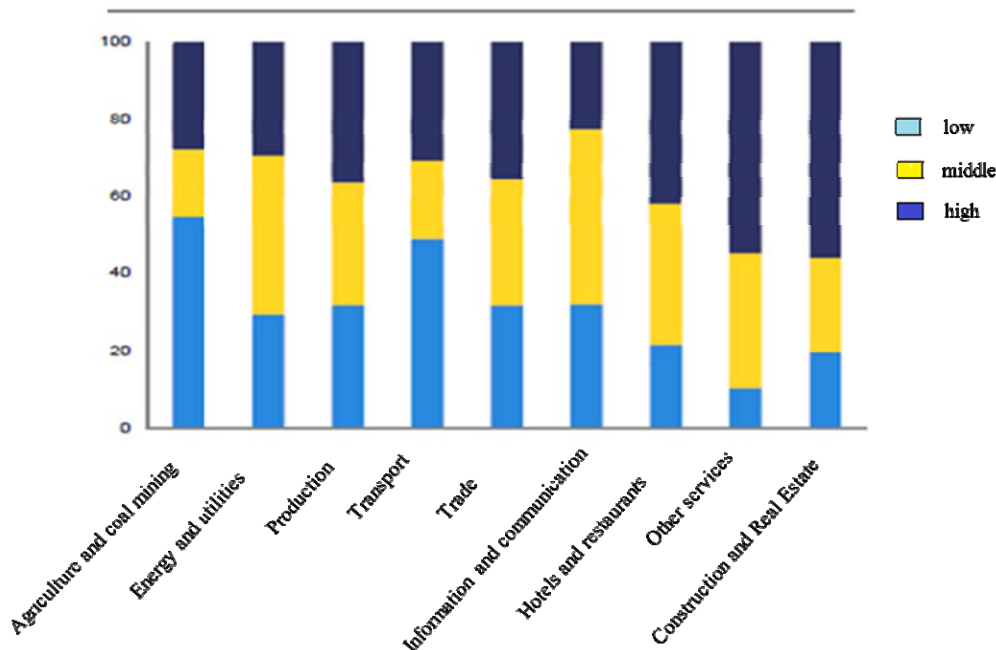
Such enterprises are more prone to economic shocks, which significantly increases the risk of insolvency. Companies in the hospitality (hotel and restaurants), construction, real estate and other service sectors face the highest risk in this respect. The commerce sector is classified by banking institutions as the sector with the lowest credit risk, therefore, despite of the financial and economic crisis, it remains the sector where most of the lending is focused.

The pressure to reduce indebtedness is more pronounced on the credits demand side. Despite of the declining interest rates registered at the end of 2009, the demand for credit is very low. The slow economic recovery, weak domestic demand, restrictive banking policy, and the accumulated large debt contribute to this situation. The pressure to reduce corporate indebtedness has a serious impact on the decline in the employment in the country.

In a difficult financial and economic environment, the banking sector as well as the business realized that human capital is the most important resource for exiting the crisis, achieving strategic goals, preserving market share and delivering growth in the human capital. Its development and

investment in training has become a kind of strategic move by which the banking sector has found a way out of the crisis.

Figure 7. **Sustainability risks by sectors**



Source: ORBIS database.

The strategic management of commercial companies in times of crisis requires minimization of risk in several main directions: capital provision, material security, suppliers, personnel, location (regional disposition), social, physical. In the conducted survey, respondents made a priority risk classification and the results are presented in percentages. The classification of risk levels is made for three reporting periods *(2008-2010, 2011-2013, 2014-2015).*

From the data presented in Table 3, it is clear that the highest burden on the retail chains is the *capital adequacy* and the extent to which the firm is able to provide timely payments. Maintaining stable financial status is a priority for all three periods. Maintaining this stability is done with the help of commercial banks. Trade succeeds in covering the newly introduced bank rules for Bulgaria. It can be summarized that there is in place a flexible and rational policy on the part of commercial chains and commercial banks. During the last reporting period, Carrefour bankruptcy resulted from irrational cash flow management, high indebtedness and inability to meet obligations.

Table 3. **Classification of major types of risk for the retail chain**

Priority classification of risks for Retail Chain (RC)			
Types of risk	**2008-2010**	**2011-2013**	**2014-2015**
Suppliers	15	12	14
Sufficient amount of materials	18	12	14
Sufficient staff in the RC	14	20	22
Sufficient amount of capital	22	24	23
Regional location	8	10	12
Social	5	8	11
Physical	18	14	4*

Source: Processing and Analysis of an Interview Survey.

* The decline is due to the successful implementation of supply management systems

The strategies for managing, controlling and minimizing risk are fundamental to the banking sector, and its proper management directly affects commercial companies. The commitment of the two sectors shows that banks and trading chains are business partners and their stability is mutually interconnected. The implementation of risk policy by the banking sector in the retail chains would have a positive impact on the balance of revenue and the expenditure side. Its use would ensure good cash flow structuring and the minimization of liquidity risks.

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YEAR LXX, BOOK 3 – 2017

CONTENTS

A. Nakonechna
A. Laktionova
Financial Architecture Adaptation of Enterprises: Quantitative Dominants in the Cyclical Economic Development / 3

Teofana V. Dimitrova
Evaluating the Strategic Position of an Organisation through SPACE Analysis / 19

Velin S. Stanev
Historical Periodization of Advertising – Problems and Intentions / 33

Denitsa Zagorcheva
Yordanka Velcheva
Budget Decentralisation as a Factor for the Simultaneous Development of Municipalities and the Industrial Business / 46

Desislava V. Petrovska
Strategic Risk Management / 60

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