FACTORING AS A FORM OF FINANCING SMALL AND MEDIUM-SIZED ENTERPRISES IN SERBIA

Aleksandra Bradić-Martinović[1]
Nemanja Nedović[2]
Mladenka Balaban[3]

Abstract:
Development of small and medium enterprises has an effect on economic growth and that is especially important in the case of open economies. Survival, growth and development of small and medium enterprises are primarily determined by the possibility of financing from affordable sources. Limited access to external sources of financing, on the money and capital markets, especially regarding the price and terms of use, is possibly the most important characteristic and the biggest problem of these enterprises. The goal of this paper is to show factoring as one of the possible alternatives which could overcome the limitations in small and medium enterprise funding. Global trends indicate that the volume of factoring increases from year to year, at an approximate rate of 20%. The factoring market in Serbia has grown steadily during the last six years, with 30% an average annual rate of growth, with currently 21 factoring market participants (10 banks and 11 factoring companies).

Key words: *financing, small and medium enterprises, factoring, Serbia*

1. INTRODUCTION

Economic growth of every country is related with the development of the financial system (Ayyagari et. al, 2010, p. 3948, Jalil&Ma, 2008, p. 51). Levine (1997, p. 720) has additionally pointed out the empirical researches done on various levels, including studies of individual companies, economic sectors, individual countries and the studies conducted on an international level, which have confirmed a strong positive influence of a stable and reliable financial system on long term economic growth. Some authors (FitzGerald, 2006), have pointed out that it is hard to establish such a clear connection in the short term and that this relationship

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[1] Aleksandra Bradić-Martinović, PhD, research fellow, Institute of Economic Sciences, Belgrade.
[2] Nemanja Nedović, Bsc, teaching assistant, Belgrade Banking Academy.
[3] Mladenka Balaban, PhD, Associate Professor, Institute of Economic Sciences Belgrade and AXA Groupe.

depends on institutional infrastructure, market depth and financial liberalization. Besides that, some research has shown (Wennekers&Thurik, 1999) that development of small and medium enterprises have an effect on economic growth. That is especially important in the case of open economies, because the globalization and the application of information and communications technology influence structural changes and reallocation of resources. These enterprises represent the most efficient part of the economy in almost all countries of the world. They have the biggest contribution to the increase of employment, gross value added and turnover and that is why they are considered to be the backbone of growth and the development of national economies. Their role is particularly important in transitional countries which are facing with the problems of high unemployment, low economic activity, insufficient competition and lack of investments, with existence of large inefficient state owned companies. European commission consistently points out the idea that economic success of the entire European Union, to a great extent, depends on the growth and financing of small and medium enterprises. This idea is incorporated in all important documents: Europe 2020, the EU's growth strategy, the Commission's Single Market Act and the Small Business Act, and it was the basis for the introduction of accompanying institutions and programs (USAID Serbia, 2012). Besides that, studies has shown (Snodgrass & Biggs, 1996, p. 252) that a small number of countries, without large natural resources, have successfully built a modern, industrialized, export economy without a significant contribution of small and medium enterprises.

Survival, growth and development of small and medium enterprises are primarily determined by the possibility of financing from affordable sources. Limited access to external sources of financing,[4] on the money and capital markets, especially regarding the price and terms of use possibly represents the most important characteristic and the biggest problem of these enterprises (Erić et al., 2012, p. 1). Because of that planning the needs for capital and planning the sources of company's financing demands a series of decisions that stem from the following dilemmas: finance from own or borrowed sources, how much capital to raise from borrowed sources, secure the capital from banks and other financial institutions, on the securities market or by attracting formal and informal investors, what capital structure a company wants to have, etc.

The goal of this paper is to show factoring as one of the possible alternatives which could overcome the limitations in small and medium enterprise funding. After the introduction, in the second part of the paper factoring is represented as a concept of transferring the receivables form commercial contracts. In this part we describe the

[4] External financing involved various sources of financing, including grants/subsidized bank loans, bank overdrafts, bank loans, trade credits, leasing/hire purchasing/factoring, debt securities, subordinated loans and equity.

details of processes and relations that are established as a part of this arrangement. Also, second part contains major general trends in this area. The third part includes the overview of the current situation in this field in Serbia, while the conclusion contains massages that can still be applied in the case of small and medium enterprises.

2. FACTORING AS AN OPTION FOR FINANCING OF SMES

Factoring is a process where the lender (*factor*) underwrites the extension of credits by purchasing accounts and notes receivables of a given company, consequently, customers of this company are notified about the transfer of debt from the seller to the factor. Factoring account receivable can be also seen as an economic decision whereby a specialized firm assumes the responsibility for the administration and control of a company's debtor portfolio. It can be considered as a method of raising short-term capital based on the selling of trade debts at a discount, or for a prescribed fee plus interest. The factor's overall profit is the difference between the price it paid for the invoice and the money received from the debtor, less the amount lost due to non-payment.

The mechanism of factoring involves interactions between three types of firms or economic agents: the client firm, the customer firm, and the factor. The factoring company provides working capital for the client firm by exchanging the account receivable for cash. It assumes the credit risk for the accepted accounts, and therefore takes full responsibility for the solvency of such customers to the extent of the accepted or approved amounts (i.e. provision of credit management). It also checks the credit and collects the accounts of these customers (i.e. sales accounting services).

Erić et al. (2012, p. 132) point out that factoring is primarily intended for small and medium enterprises that traditionally have harder access to bank loans, because of low credit capacity or inadequate collateral and is one of the best ways of securing a fast and safe payment of accounts receivable, based on the sale of goods or services. This way of financing is important for exporters as well, because financing through advance payment enables taking the risk of collection and monitoring of receivables, which increases competitiveness and export potentials of these companies on the foreign markets.

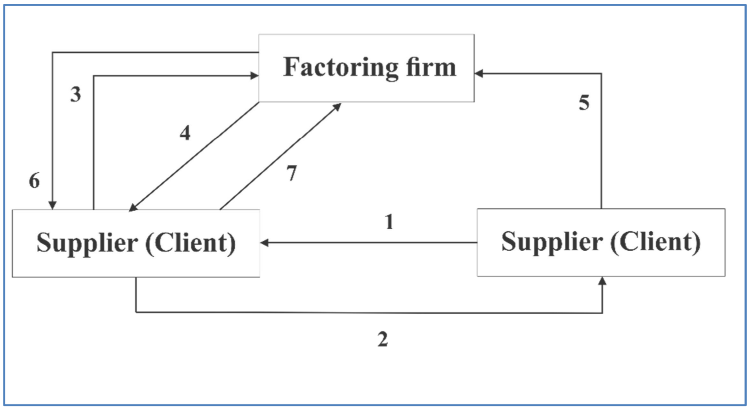
The International Finance Corporation’s (IFC, 2010) stocktaking report on SMEs to the Group of Twenty (G20) - Scaling-Up SME Access to Financial Services in the Developing World - indicated that between 45% and 55% of formal SMEs do not have access to loans from formal financial institutions in developing countries. This ratio increases to 65%–72% if informal SMEs and microenterprises are included. Almost half of EU SMEs (47%) investigated other forms of external financing (e.g. a loan from a related company or shareholders, leasing and factoring).

Factoring has a number of advantages in comparison to other forms of financing small and medium enterprises, and the most important are:
- Factoring can be customized and managed so that it provides necessary capital when your company needs it;
- The financing does not show up on your balance sheet as debt;
- Factoring is based on the quality of your customers' credit, not your own credit or business history;
- Factoring provides a line of credit based on sales, not your company's net worth;
- Unlike a conventional loan, factoring has no limit to the amount of financing and
- Factoring aligns well with start-up businesses that need immediate cash flow.

Process of factoring

Practically, factoring process involves several steps which participants in this process undertake. Figure 1 represents all participants, and the steps of the process are numbered.

Figure 1: Factoring process



Source: Soufani, 2002, p. 23

The algorithm involves the next steps:
1) Customer places order to the supplier;

2) Firm supplies goods and issues invoices;
3) Supplier firm requests financing and provides the debtor book (sales ledger);
4) Factoring company advances cash against invoices once approved based on the information
5) The customer firm is expected to make full payment to the factoring company within a stipulated period of time;
6) The factoring company charges fees and interest to the supplier; and
7) If the customer firm defaults on payment, the client firm must repay the factoring firm.

Types of factoring

There are several divisions of factoring by types, but we shall present three general divisions. First division represents four main types:[5]

a) *In maturity factoring* (also called service factoring), the factor maintains the seller's sales ledger, controls credit, follows up on the payments, and pays the amount (after deducting a commission) of each invoice as it falls due, whether or not the payment was collected.
b) *In finance factoring*, the factor (called the financing factor) advances funds to a producer or a manufacturing firm, on the security of produce or goods that will be produced or manufactured utilizing those funds.
c) *In discount factoring* (also called service plus finance factoring) the factor advances a percentage (usually between 70 to 85 percent of the value of accounts receivable) to the seller on a non-recourse basis and assumes the full responsibility of collecting the debts.
d) *In undisclosed factoring*, a factor buys the goods from a primary party (producer, manufacturer, or seller) and then appoints the same party as its agent to resell those goods and to collect the payments. This arrangement prevents the disclosure that goods are being sold under a factoring agreement. The undisclosed factor, as in all other types of factoring, remains liable for uncollectible payments. Factoring is a type of 'off balance sheet financing.'

According to the contractual relationship between the participants, factoring can be (Erić et al., 2012, p.126):

a) *Domestic* (buyer and seller of goods or services are in the same country) and international (buyer and seller are in different countries, turnover is considered to be an export import operation and can be done in a single

[5] See in details: *http://www.businessdictionary.com/definition/factoring.html#ixzz3NxN62DMp*

factor or a two factor system; unlike domestic factoring as a way to finance domestic trade, international factoring represents a way of financing international trade, and as such is an important incentive for export financing)

b) *With recourse* (involves a solidary obligation for the debtor and the assignor and the right for the factor to demand payment from the debtor, assignor or both of them at the same time, within the limits of their obligations, unless contracted otherwise) and *without recourse* (the factor assumes the default risk of the receivable).

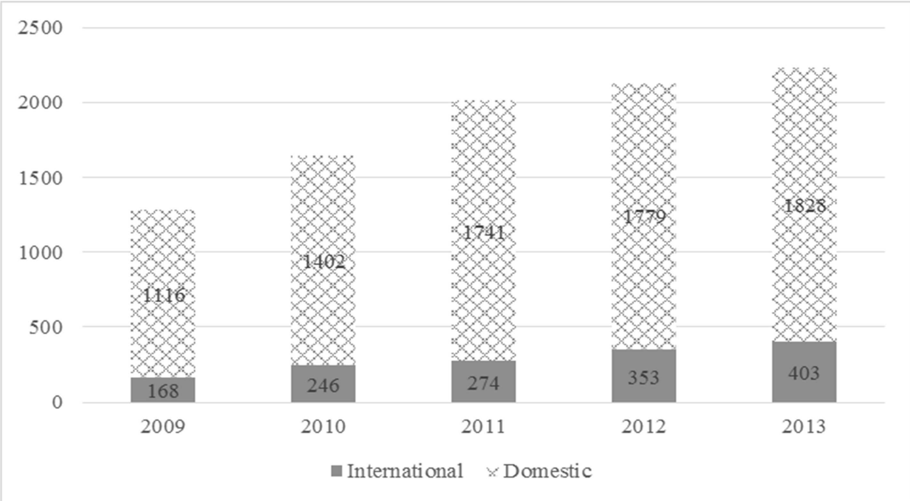
Hubbard (1987, pp. 72-76) points out that we can distinguish between *maturity factoring* (the customer only expects to receive the full payment of the invoice in maturity date capitalizing on the credit protection given by factor) and *discounting factoring* (the customer receive a sight payment, as a discount, against assignment of the invoice to the factor). He also added a so-called *overadvance factoring* which implies financing of customer's inventory (purchases) in anticipation of a assigning of future receivable will be created after sale of this inventory. This practice ideally suits business with seasonal purchases/sales.

Global trends

According to the data providing by Factors Chains International (FCI)[6] the world's most important factoring network the total worldwide volume for factoring had a modest increase in 2013 of nearly 5% growth in Euro or nearly 10% in U.S. dollars compared to 2012. The world factoring total stands now at € 2,230 Billion. Overall, the factoring industry has weathered the financial crisis and subsequent global recession much better than many other providers in the financial services sector. Figure 2 represents the increase of global factoring volume in the period from 2009 to 2013. The data shows that the global factoring volume increased by 15% in this period, at the same time domestic factoring increased by 24.8%, and international increased by 18%. The increase in cross border factoring has been driven by an rise in open account trade, especially from suppliers in the developing world, pushed by the major retailers/importers in the developed world, including the acceptance of factoring as a suitable alternative to traditional forms of trade finance.

[6] *http://www.fci.nl/news/detail/?id=502*

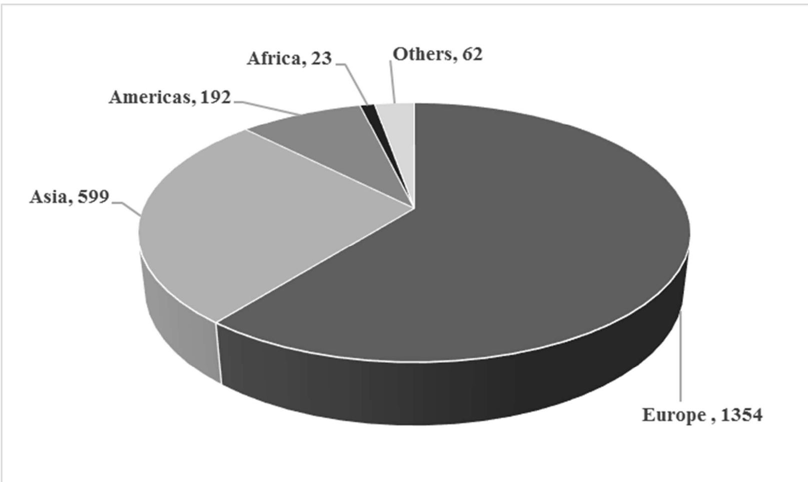
Figure 2: Global factoring volume (EUR billion)



Source: Factors Chains International, www.fci.nl

From a regional perspective, Europe is the largest factoring market in the world, accounting for 60% of the world total and the region increased by 4.3% compared to the previous year. Asia is the second largest, accounting for 27% of the world total and the region increase by 4.7%. And the Americas is the third, accounting for 9% of the world total, increasing by 2.1%. Global factoring industry in 2013 presented by regional factoring volume is presented in Figure 3.

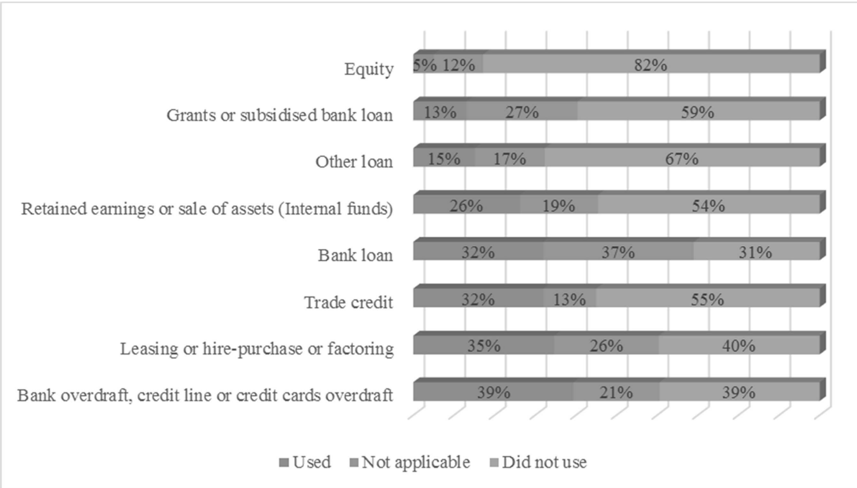
Figure 3: Global factoring industry in 2013 by region (EUR billion)



Source: Factors Chains International, www.fci.nl

The EC and the European Central Bank (ECB) decided in 2008 to collaborate on a survey on the access to finance of SMEs in the European Union and established the Survey on the Access to Finance of Small and Medium-sized Enterprises (SAFE). The survey, conducted across 37 countries, including the 28 European Union (EU) and 17 euro area countries was undertaken in June-July 2009, in August-October 2011 and most recently in August-October 2013. The question in this survey that was especially interesting for us, from the standpoint of this paper, referred to the use of different internal and external sources of company financing in EU in the first half of 2013. The results are represented in Figure 4.

Figure 4: Companies' use of internal and external financing in EU



Source: 2013 SMEs' Access to Finance survey

Based on the answers we can conclude that the usage of factoring in EU is very popular, because 35% of entrepreneurs answered that they have used this form of financing. That put factoring in the second place by popularity of financing sources, just behind bank overdraft, credit line and credit card overdraft. The data was to be expected having in mind that EU is the leading region for the use of factoring.

3. EVIDENCE FROM SERBIA

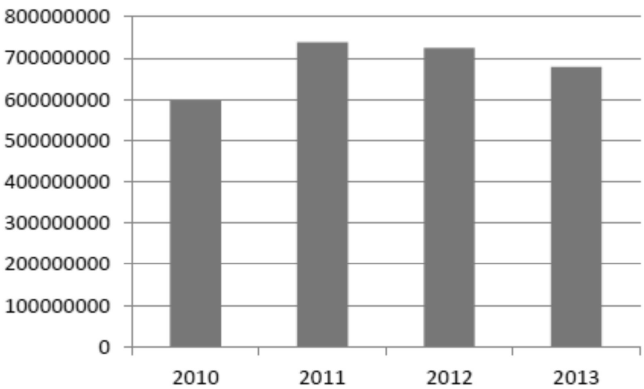
The factoring market in Serbia has grown steadily during the last six years. The factoring industry started to develop in 2005, and in the previous 6-year-period it has recorded an average annual rate of growth in excess of 30%, reaching €658 million in 2010. The existence of liquidity gap, which is a permanent obstacle for

Serbian companies, makes factoring as well as bills of exchange discounting very attractive products for clients.

Currently there are 21 factoring market participants in Serbia, out of those 10 are banks and 11 are factoring companies. The banks that offer factoring services are: Banca Intesa AD, Eurobank AD, Erste banka AD, Komercijalna banka AD, OTP banka Srbija AD, Raiffeisen banka AD, Societe Generale bank Serbia AD, Unicredit banka AD, Sberbank Srbija AD. Factoring companies that operate in the market are: Afaktor- faktoring finansiranje DOO, AOFI- Serbian Export Credit and Insurance Agency, Balkan faktoring DOO, Ekspres Gradina DOO, Finera Factoring DOO, Focus Factor Plus DOO, Gamico Factoring DOO, Jubmes Faktor DOO, Profinance DOO, Prvi Faktor- Faktoring, Real Factor DOO. The market participants are organized within the Belgrade Chamber of Commerce- Association of financial organizations, the Section for factoring development. Some of them are members of international factoring associations such as IFG, IFC and FCI.

The annual survey of factoring market turnover in 2013, presented in Figure 5, has shown a 6.21% percent decrease of total turnover in comparison with 2012. If we have in mind that 2012 turnover was 11.8% smaller than the turnover in 2011, we can see a downward trend developing. We must be careful when interpreting the data given in the survey because the number of market participants did not deliver their data. When we compare the year to year turnover data for 8 factoring companies, we can see an annual increase of 6.26%. Four factoring companies and one bank have recorded significant increases in their annual turnover, while other banks record significant decreases.

Figure 5: Factoring turnover in Serbia



Source: 2013 BCC Factoring turnover survey

Turnover structure show changes compared to 2012. International factoring shows decrease of 19.21%, while domestic factoring shows a decrease of 5.32% when comparing the 8 factoring companies. Six banks that have sent their annual data have shown a significant 26% decrease of international factoring and an 18.64% decrease of domestic factoring.

Factoring with recourse shows increases in factoring companies turnovers, while banks experienced a 30.33% decrease. Factoring without recourse has shown a 41.78% increase when compared to 2012. Bills of exchange an invoice discounting have shown a small increase when compared to 2012.

Table 1: Factoring market overview in Serbia (2012-2013)

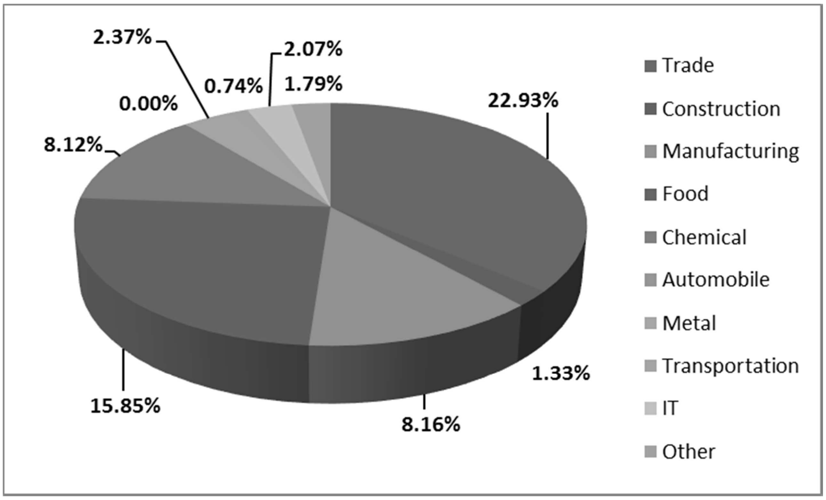
Structure	2012	2013	INDEX
Number of participants	12	14	116,67
Number of banks	4	6	150
Number of factoring companies	8	8	100
Total turnover	724.196.340,86	679.248.122,67	93,79
Domestic factoring	678.055.215,86	641.969.627,67	94,68
Domestic factoring participation	93,63	94,51	100,94
International factoring	46.141.125	37.278.495	80,79
International factoring participation	6,37	5,50	86,34
Factoring with recourse	649.035.681,39	590.804.582,21	91,03
Factoring without recourse	31.725.753	44.982.046,50	114,78
Silent factoring	28.500.000	11.298.000	39,64
Reverse factoring	/	17.754.000	/
Invoice discounting	40.150.313,36	45.587.546,14	113,54
Bill of exchange discounting	221.288.878,51	235.859.584,44	106,58
Bank turnover	340.339.000	271.352.000	79,73
8 factors comparison	383.857.340,86	407.896.122,67	106,26
6 banks comparison	340.339.000	271.352.000	79,73
Bank participation in total turnover	46,99	39,95	85,01

Source: 2013 BCC Factoring turnover survey

In 2013, Law on factoring has been adopted by the National Assembly of the Republic of Serbia. Throughout 2014 Ministry of Finance, Administration for the Prevention of Money Laundering, Serbian Business Registers Agency and USAID has been working on the implementation of the Law. The appropriate Bylaws have been adopted, and factoring companies have been registered in accordance with the Law in the Serbian Business Registers Agency.

The further development of the factoring industry in Serbia is found to be a result of two factors: a) newcomers to the factoring industry, and b) an affirmation of the factoring product on the market. If we take into account that this development was achieved during the period of financial crisis and in the condition of highly restrictive credit policy applied by most of the factors at the Serbian market, the conclusion is that the affirmation of factoring industry is quite progressive. The use of factoring as financial option becomes a significant step to increase the liquidity in the periods of crises by providing the accounts receivables as the collateral to acquire finance. The ongoing processes at the factoring market send positive signals for the future of this industry in Serbia.

Figure 6: Factoring - industry sector structure in Serbia (2013)



Source: 2013 BCC Factoring turnover survey

The growing number of factoring companies is going to impact the future development and growth of the factoring sector across the Serbian financial market. Positive impacts arise from increased service innovation, lower costs of factoring, improved accessibility to servicing smaller businesses, and finally, higher future factoring volumes.

Belgrade Chamber of Commerce with the help of USAID will organize a number of presentations and workshops with a goal to better inform the businesspeople and the representatives of business about the factoring services, and the advantages they give to companies.

The regulatory framework that defines factoring is expected to be improved in 2015 especially in regard to the amendments to the Law on factoring and the Anti-money laundering legislation.

4. CONCLUSION

Factoring has a long history and roots in international trade. At the beginning of the twenty-first century, factoring has become one of the financing methods for innovative and rapidly growing firms, which are not creditworthy. Factoring also enables faster turnover, which ensures that SMEs can survive and grow in a competitive environment. The use of factoring as financial option becomes a significant step to increase the liquidity in the periods of crises by providing the accounts receivables as the collateral to acquire finance.

Global trends indicate that the volume of factoring increases from year to year, at an approximate rate of 20%. Judging by the number of factoring companies, Europe is the dominant region in this area.

The ongoing processes at the factoring market send positive signals for the future of this industry in Serbia. The factoring market in Serbia has grown steadily during the last six years, with 30% an average annual rate of growth. Currently there are 21 factoring market participants in Serbia, out of those 10 are banks and 11 are factoring companies. The regulatory framework that defines factoring is expected to be improved in 2015 especially in regard to the amendments to the Law on factoring and the Anti-money laundering legislation.

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