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# SMALL AND MEDIUM ENTERPRISES: FINANCIAL INFORMATION AS A CATALYST FOR LENDING

## Results of a Survey on Bank Lending Practices in Serbia



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# CFRR

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## About the World Bank CFRR

This report is a product of the World Bank Centre for Financial Reporting Reform (CFRR). The CFRR, located in Vienna, Austria, is part of the World Bank's Governance Global Practice and is responsible for the World Bank's corporate sector financial reporting activities in Europe and Central Asia.

The Centre helps client countries build sound accounting, reporting, and auditing practices, which bring sustainable and equitable private sector-led growth, strengthened governance, and accountability.

The CFRR also provides knowledge services, including analytical and advisory services, learning and skill development, know-how and knowledge transfer, and technical assistance to strengthen existing institutions.

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The objective of EU-REPARIS is to support the implementation of corporate financial reporting frameworks in line with the EU *acquis communautaire* in the countries of Southeast Europe, with a view towards promoting enhanced availability, transparency, and reliability of financial information.

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## EXECUTIVE SUMMARY

### Background

Small and Medium Enterprises (SMEs) contribute significantly to jobs and output creation, and are seen as engines of economic growth worldwide.<sup>1</sup> However, many studies have found that SMEs find it difficult to obtain financing at the start-up stage and beyond, thus constraining their growth prospects. The World Bank estimated that 50 percent of SMEs do not have access to formal credit and that, globally, the current credit gap for SMEs is US\$1.2 trillion (Bell 2015). Therefore, addressing the SME “financing gap” has become a priority for governments and development organizations, given their important economic and societal role. As a result, a number of initiatives have been launched to improve SME financing, including government-subsidized lending, public guarantees, and other risk-sharing facilities.

In Serbia, SMEs represent 99.8 percent of registered companies, 65 percent of total employment, 56 percent of total gross value added, and 44.8 percent of total exports (OECD 2017). Because of underdeveloped capital markets and limited alternatives to bank financing, banks are the key providers of external finance to SMEs in the country.<sup>2</sup> Although some recent estimates show that the overall supply of financing outweighs the overall demand for loans in Serbia, there is a lack of financing for longer term and local currency loans, especially for smaller enterprises, as well as a shortage of loans without collateral requirements (EIB 2016). Furthermore, banks typically exclude companies that are at the seed and start-up business life cycle stages to focus on companies in the growth stage and beyond.

### About this study

This paper presents the findings of a survey of bank lending practices to SMEs in Serbia conducted by the World Bank Centre for Financial Reporting Reform (CFRR)<sup>3</sup> at the end of June 2016. It is based on the results of survey questionnaires and interviews with one local and five foreign-owned banks, which together account for approximately half of the Serbian banking market.<sup>4</sup> This study evaluates current banking practices, as well as challenges and expectations relating to financial reporting and auditing in lending decisions. It also assesses how banks measure the quality of the financial information they receive as part of a loan application.

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<sup>1</sup> According to the World Bank, formal SMEs contribute up to 60% of total employment and up to 40% of national income (GDP) in emerging economies (Bell 2015).

<sup>2</sup> Banks provide the vast majority of the financing to SMEs, although there is also a small but successful leasing sector, which is directed primarily at SMEs. An equity finance industry has emerged during the past five years, with some limited private equity and venture capital now available in the local market.

<sup>3</sup> [worldbank.org/cfrr](http://worldbank.org/cfrr)

<sup>4</sup> These six banks account for 46% of market share as of the end of 2015.

## SME Banking in Serbia

The survey finds that SME banking is of strategic importance in Serbia. Banks define SMEs as companies having annual sales between EUR 750,000 to EUR 50 million. Smaller companies are typically classified with households as retail clients, while medium companies are classified together with larger corporate clients. SME banking is a very profitable segment with many growth and cross-selling opportunities.<sup>5</sup> As a result, there is intense competition between banks to attract and retain good SME customers.<sup>6</sup> Overall, this competition has led to a broader range of services and lending products offered to SMEs, and to a reduction of lending fees. Despite these developments, the cost of financing remains relatively high and access to loans remains difficult. While some supply-side factors are obstacles to SMEs financing in Serbia, the survey findings point mainly to demand-side issues.<sup>7</sup> In particular, the study highlights the following:

## Key Findings

**Financial information carries significant weight in the SME loan decision process in Serbia, whereas pure collateral-based lending has been phased out.**<sup>8</sup> Five out of the six banks surveyed request unaudited financial statements as part of their credit application. Financial statement lending is ranked as the most popular lending channel for SMEs classified as retail and corporate clients, while pure asset-based lending (i.e. banks look at collateral as the primary source of repayment) is used the least. Financial statement lending and relationship lending are used equally frequently for SMEs classified as corporate clients. Loans are mainly granted on the basis of an applicant's repayment capacity.

**Most of the banks surveyed use credit scoring models for approving loans to smaller companies (i.e. SMEs classified as retail clients).** These models weigh several criteria, including SMEs' profitability, liquidity, and financial and sectoral risks. The use of financial information in these scoring models is quite high and varies between thirty to seventy percent, depending on the bank surveyed. Banks are therefore highly dependent on the quality of SMEs' financial information.

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<sup>5</sup> According to the survey, in both the retail and corporate categories, the contribution of SMEs to banks' net incomes is higher than the SME share in the banks' lending portfolio.

<sup>6</sup> The banks surveyed report that an SME owner tends to have accounts with four or five banks, on average, and shops around for the most favourable terms.

<sup>7</sup> Supply-side issues include high cost of financing, poor product suitability, few alternative sources of financing, inefficient credit enforcement, and regulatory disincentives. Demand-side issues include borrower attitude and risk aversion, weak capacity to present business plans, unsuitable collateral, liquidity constraints, and weak SME market leverage.

<sup>8</sup> Since 2005, all companies registered in Serbia have to prepare financial statements and submit them electronically to the Agency for Business Register (APR) by June 30th of each year. All companies except micro-entities prepare annual financial statements including a balance sheet, income statement, statement of other comprehensive income, statement of changes in equity, statement on cash flow, and notes to financial statements (ROSC Serbia, 2016).

**There are a number of SMEs for which banks have not yet developed an effective way to provide credit.** These are SMEs that are too large to be assessed by scoring models, but also too small to be worthwhile to invest considerable time in relationship building. Improvements in the quality of financial reporting of these companies would harness positive results for both banks and SMEs. A more user-friendly loan application process, including standard templates and educational materials, would further facilitate the credit process.

**Weak SME financial management skills is the most significant obstacle to access financing, leading to delays in lending decisions and increasing cost of finance.** SMEs lack effective financial management skills, which constrains their ability to clearly identify and express their financing needs and to report their financial information reliably. Unrealistic business plans and assumptions require greater diligence on the part of loan officers, which leads to delays in the application process. Furthermore, SMEs may not use financing products efficiently, e.g. using working capital loans for investment purposes. Anecdotal evidence also suggests that there is an important “unexpressed demand” for external financing among SMEs (i.e. SMEs are not able to judge when and how much financing they need). The fact that about one-third of SMEs request loans to refinance their debt could be a further indication of their poor cash-management abilities. As a result, several qualitative factors are used to initially screen and filter loan applications, taking into account the competencies and experience of SME owners, their payment history, number of years of activity in the sector, etc.

**Low reliability of financial statements and insufficient disclosures (particularly resulting from operations in the informal economy) make business risk and true profitability difficult to assess, further restricting access to credit and driving up costs.** SMEs rarely present detailed information about the maturity structure of their receivables and payables, stocks, inventory and unfinished products. SMEs’ current portion of debt is often not separated from long-term debt, companies are not consolidated, and related party transactions go unreported. This makes it difficult to understand companies’ total indebtedness and dependencies. Consequently, business risk is difficult to assess. The importance of the informal economy is a major issue that affects the quality of financial statements. Figures reported in financial statements are not always reliable. Profit, for example, is typically underreported to avoid paying taxes.

**Banks need up-to-date, periodic financial information, but such information from SMEs tends to be of poor quality.** A major obstacle to bank lending is the lack of timely and reliable interim financial information from SMEs. Annual financial statements are usually not sufficient for loan applications, and banks customarily request companies to submit up-to-date, interim financial information, including trial balances. Interim financial information provided by SMEs tends to be of poor quality and is often not presented clearly, which causes delays in the loan application process.

**All the banks interviewed see external audits as important for enhancing the reliability of the information provided by SMEs; however, too few audits are performed and their quality is uneven.** Financial statement audits are only performed for medium and large-sized firms, which face a statutory audit requirement. According to the banks surveyed, less than five percent of smaller firms provide audited financial statements despite not being legally obliged to do so. Banks believe that they would be less competitive (time- and cost-wise) if they required audits for small companies. Furthermore, banks view the quality of audit services as uneven. The banks surveyed generally perceive the work of the Big Four<sup>9</sup> audit firms positively, but have concerns about the quality and independence of small and medium audit firms. Most SMEs try to minimize spending on accounting and auditing, with commensurate impact on quality.

**Overall, shortcomings in financial reporting quality and weak financial management skills of SMEs require more due diligence from banks. This is a costly and time-consuming exercise that slows down the loan application process, increases the interest rates on loans offered to SMEs, and contributes to bank reliance on collateral and guarantees to price loans.** All the banks interviewed have created some form of internal controls to flag inconsistencies between SMEs' officially reported financial statements and the other information they provide. This extensive due diligence process is necessary to address the lack of information about and the informality<sup>10</sup> of SMEs' business practices. This costly and time-consuming process is reflected in the interest rates paid by SMEs. Furthermore, banks are still very likely to rely on personal guarantees and collateral to support loan pricing.

## Conclusion

**The surveyed banks agreed that raising the quality of financial management and financial reporting by SMEs in Serbia could have a significant, positive effect on expanding access to and lowering the cost of finance.** Experience has shown there is no silver bullet for addressing SME finance issues. Rather than providing *the solution* to the financing gap, this study instead offers *one more solution* to assist in closing this gap. Improving financial capacity of SMEs is not a short-term endeavor; however, such efforts could effect sustainable improvements in SME access to finance in the medium- to long-term, without distortionary effects to the market.

**The study has also revealed that banks in Serbia have been exploring ways to become more efficient.** For example, they have been looking for ways to decentralize or streamline their lending procedures. By approving small ticket loans directly at branches or using tech-

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<sup>9</sup> The Big Four audit firms in Serbia include Ernst & Young, PricewaterhouseCoopers, KPMG, and Deloitte.

<sup>10</sup> The untaxed "grey" economy in Serbia costs the country about 30 percent of its GDP, according to the independent Serbian Fiscal Council (Dragojlo 2015).

nologies such as online advisors, banks have been able to reduce the processing time of loan applications that could otherwise require approvals from the credit institution's headquarters. Additionally, banks are seeking to simplify required loan documentation for SMEs, with a view that requirements should be proportional to the size of the company and the risk taken by the bank. Further, banks have been developing specialized products for SMEs based on their sector of activity or business life cycle.

**The survey also points to some ideas for tools and concrete actions that could be undertaken to improve the quality of SME financial reporting, and consequently SME financing prospects.** Such improvements could reduce the cost of bank due diligence processes and contribute to increased competition and more favorable financing terms, while reducing reliance on collateral and personal guarantees. Specific improvements include:

- **Creation of a standard template to supplement loan applications, which would convey key financial information in a straightforward manner.** Such a template would enhance the completeness, timeliness, and reliability of financial information submitted as part of the loan application. It would enable banks to have a more complete financial picture of potential SME clients, including targeted information on business risks and profitability.
- **Use of a limited assurance product to review key aspects of SME financial information.** This would be a step down from a full audit, and ideally would be developed together with the accounting and audit profession, banks, SME associations and other relevant stakeholders. It would focus on some key areas of weakness in SME financial statements, e.g. account payables and receivables, inventory and stocks, indebtedness, related party transactions and profitability.
- **Capacity development for SMEs to better identify and express their financing needs in line with their growth strategy.** In this regard, a capacity-building exercise could be undertaken, focused on the specific business and finance needs of SMEs. Such an initiative would allow SMEs to readily identify competent service providers. A potential partner for this exercise, in addition to the accounting profession, is the Chamber of Commerce (CoC) of Serbia which already plans to provide counseling services and an online platform to train SMEs in financial literacy.

## INTRODUCTION

Small and medium size enterprises (SMEs) are key players in the current and future Serbian economy. SMEs alone represent 99.8 percent of registered companies, 65 percent of total employment, and up to 54 percent of GDP (OECD 2017). Underdeveloped capital markets and limited alternatives to bank financing stymie opportunities for growth and expansion of SMEs. In recent years, a small leasing sector and an emerging equity finance market have begun supplying limited private equity and venture capital to SMEs. Banks, however, remain the primary provider of external financing for SMEs in Serbia.

Banks face several issues in lending to SMEs. First, banks must pay higher costs to assess and monitor SME investments and serve their smaller transactions. Smaller firms often do not have audited financial statements, or updated financial information. This informational opacity, as compared with larger firms, prevents small businesses from credibly conveying their potential to lenders, thus resulting in higher funding costs and loans with shorter maturities.

Creating an enabling environment for SME growth requires reducing information asymmetry between SMEs and their financing providers. The findings of our study confirm that having informative, reliable, and readily available financial information (including reviewed or audited financial statements) could be an important part of the solution.

## About the Survey Methodology

The report is based on the results of survey questionnaires completed by one local and five foreign-owned banks. These six banks accounted for 46% of the Serbian banking market as of end-2015.

An initiation event for this project was held in March 2016, which coincided with the Government of the Republic of Serbia's year of entrepreneurship. Participation at the event demonstrated strong interest and engagement on the SME agenda, including from government authorities (including the Ministry of Finance, the Ministry of Economy, and the National Bank of Serbia), the accounting and auditing profession, academia, banks, and the development community such as the EBRD and USAID.

Completed survey questionnaires were sent back to CFRR in June 2016. The team conducted follow-up interviews and then shared and discussed the initial survey findings during a second mission in September 2016.

This report consolidates information obtained through the surveys, as well as the interviews conducted with banks.

## MAIN FINDINGS

Banks are the main source of external capital for Serbian SMEs. Our survey of the top six banks in Serbia provide several key insights into the methods these banks utilize to make SME financing decisions and the opportunities that exist for improving SME access to finance. First and foremost, the survey confirmed the importance of high quality financial information in securing credit. Banks ultimately wish to determine a company's ability to repay a loan. They can do so by calculating a credit score for the company based on its profitability, liquidity, financial and sectoral risks, and other information obtained from its reported financials. Poor quality financial statements and weak financial management practices require banks to carry out more significant due diligence, which creates delays in lending decisions and increases credit costs. Prevalent SME operations in the informal economy also present difficulties in obtaining reliable or detailed financial records. All of these issues contribute to restrictions in lending to SMEs in Serbia.

The eight key findings presented below reveal a consensus among the banks that raising the quality and reliability of financial reporting could significantly and positively expand access to finance for SMEs in Serbia.

### **1. Financial information carries significant weight in the SME loan decision process in Serbia, whereas pure collateral-based lending has been phased out.**

Five out of the six banks surveyed request unaudited financial statements as part of their credit application. Financial statement lending is ranked as the most popular lending channel for SMEs classified as retail or corporate clients. Financial statement lending and relationship lending are used equally frequently for SMEs classified as corporate clients. Pure asset-based lending (i.e. banks look at collateral as the primary source of repayment) is used the least. Loans are mainly granted on the basis of an applicant's repayment capacity.

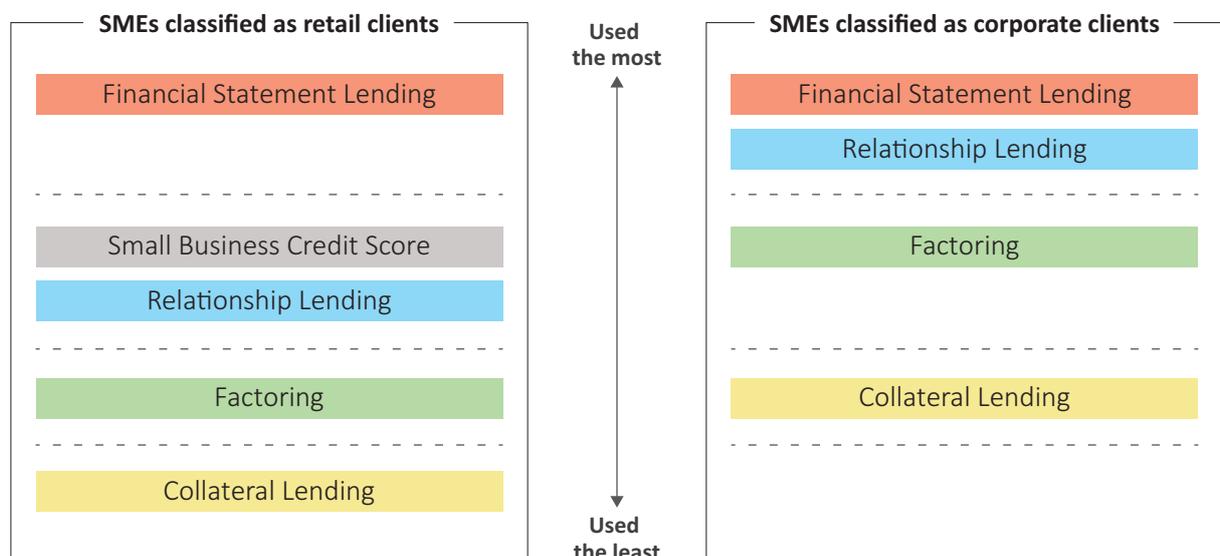
**Financial statements are widely used by banks in Serbia for making credit decisions; their relative weight in the application as compared to other factors varies depending on the size of the SME (i.e. whether it is classified as retail or corporate) and the type of loan being requested.**

Since 2005, all companies registered in Serbia are required to prepare and submit financial statements to the Agency for Business Register (APR) by June 30<sup>th</sup> of each year. All companies except micro-entities must submit annual financial statements including a balance sheet, income statement, statement of other comprehensive income, statement of changes in equity, statement on cash flow, and notes to financial statements. Micro-entities are required to submit only a balance sheet and income statement (World Bank 2016). Five of the six banks surveyed require unaudited financial statements as part of a loan application. Financial statements are provided by 92% of SMEs classified as retail clients and 95% of SMEs classified as corporate clients. Banks typically require at least two years of financial statement history to finance an enterprise. Start-ups and micro-enterprises have the lowest level of access to loan funding.

Business plans are usually required for loans with a longer maturity or when the perceived client risk is high (for example, when a loan is requested for the issuance of a new product or when the business proposition is new or innovative). Owners' personal information is especially important when banks are dealing with new customers. Independent verification and valuation of assets is legally required and of importance to banks.

**The preferred channel for lending to SMEs classified as retail clients is financial statement lending, followed by credit scoring and relationship lending. For SMEs classified as corporate clients, financial statement lending and relationship lending are the primary lending channels.**

**Figure 1: Use of lending channels for SMEs classified as retail and corporate clients**



### Financial statement lending

In financial statement lending, a bank underwrites a loan based on the strength of an SME's financial statements. Banks analyze an SME's expected future cash flow to assess its ability to repay the loan. Using this method requires both informative and reliable financial statements. Banks calculate financial ratios, such as profitability and liquidity of assets, based on information from the financial statements of an SME to determine if it has a strong financial profile (Udell and Berger 2006). In Serbia, the use of financial statements ranks as the preferred channel for lending to SMEs classified as both retail and corporate clients. Using data from financial statements addresses SME information asymmetry problems in a cost-effective way, especially for larger financial institutions. For larger SMEs, where the amount of the loan is typically higher, financial statement lending is coupled with relationship lending.

### Relationship lending

Relationship lending is designed to fill information gaps that cannot be addressed using hard data. It focuses on "soft" information about the borrower, such as the reputation of the owner, the local community, and its business environment. Collecting such information is time and labor-intensive and thus quite costly. These costs tend to be passed on to the borrower in the form of higher interest rates (Udell and Berger 2006).

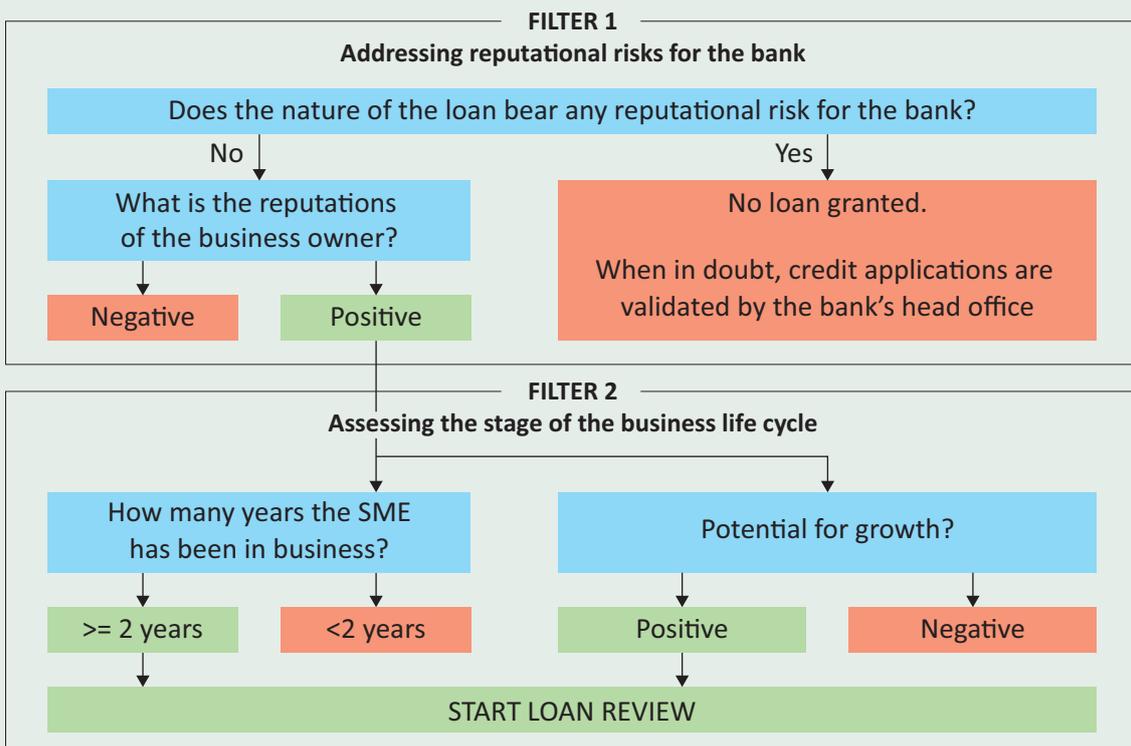
While no bank relies exclusively on relationship-based lending, all of the surveyed banks invest considerable time into getting to know their customers, particularly for corporate SMEs. Building a strong rapport with SME clients helps compensate for organizational informality and a lack of regularly updated, reliable financial statements. The main criterion for lending is still a client's repayment capacity, but its reputation and track record are systematically screened to determine whether the bank will proceed with the applicant (see Box 1 below). The two banks in the survey that do not use scoring models rely extensively on the relationship banking model for lending to retail SMEs. Their relationship lending model is based on interactions with SME owners and site visits. Despite being time-consuming and costly, the relationship with the client remains an important element of competitiveness for these banks.

#### **Box 1: The Different Stages of the Loan Application Process**

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For both retail and corporate SMEs, loan applications are initially screened for reputational risks and probability of failure. Several factors are used to initially screen and filter loan applications. First, banks carefully examine the purpose of the loan and the reputation of the SME's owners/managers. If a recognized reputational risk is identified, it generally means disqualification regardless of the company's credit risk. For

foreign-owned banks, some credit applications may be sent abroad to the bank's head office for approval. Second, banks typically exclude companies that do not have a track record (i.e. companies in the seed and start-up business life cycle stages) in order to focus on companies in the growth stage and beyond.<sup>11</sup>



After an applicant passes the initial filtering by credit bureau scores, information from the National Bank of Serbia's Solvency Center and credit ratings helps determine lending limits and collateral requirements. The reliance of banks on credit scores creates a challenge for SMEs with limited or no formal credit history. The client's checking or savings account and their transaction history are very important to banks because they help reviewers assess the client's liquidity and/or cash flow pattern in the case of seasonal businesses. Based on interviews, we find that banks recreate simplified cash flow statements using the SME owner's current account information. Banks can suggest a pre-approval rate based on this information, but this method is used only for small ticket loans.

<sup>11</sup> Banks typically require two years of existence, which automatically excludes companies in their start-up and seed stage, to focus on companies that have reached the growth stage.

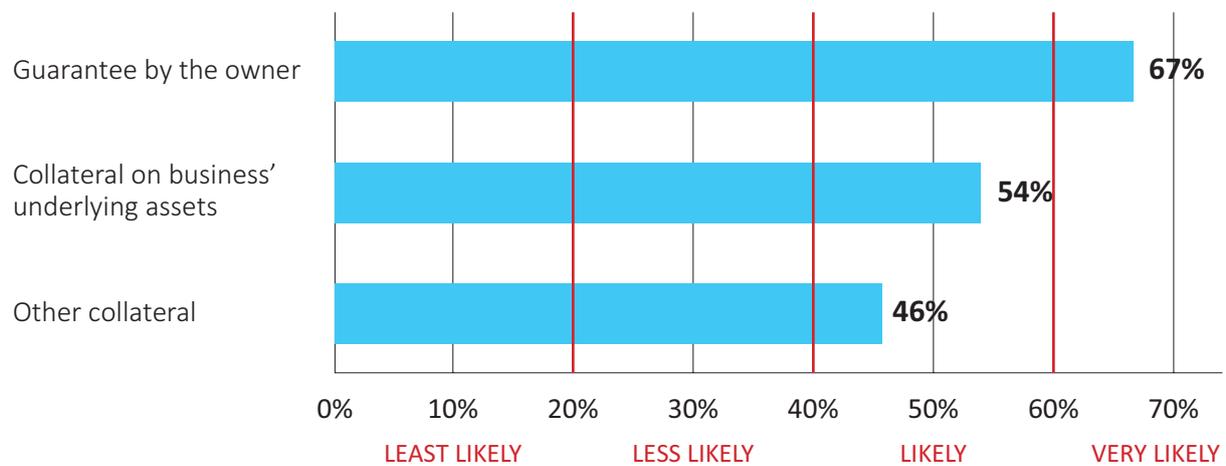
Financial statements prepared by the client are an additional “very important” factor in the credit decision. The legal structure of the business is also considered a very important factor. The credit applications of limited liability companies tend to be of better quality than those of entrepreneurs due to double-entry bookkeeping and greater transparency in their businesses. Net personal assets are taken into consideration as a comfort factor, especially in cases of unsecured lending; they are considered “important”. Experienced management is a mitigation factor when SMEs operate in a risky industry. Education is not a crucial factor, but it is a “plus” when strategic planning or cash flow management is discussed with the customer.

Tax returns are considered “less important,” which reflects the lack of trust in the reliability of statements businesses provide to tax authorities. On the other hand, any delay in tax payments is a strong negative factor in the credit approval process. Only one bank compares financial information provided as part of the credit application to tax returns for SMEs classified as retail clients. For SMEs classified as corporate clients, however, three banks compare applicant submitted financial information to tax returns.

**Pure collateral based lending is the lending channel that is used the least for both SMEs classified as retail and corporate clients.**

Under collateral based lending, the underlying assets of the firm (i.e. its collateral) are the primary source of repayment. For working capital financing, banks typically use short-term assets, such as accounts receivable and inventory. For long-term financing, they use equipment (Udell and Berger 2006). The survey results show that collateral based lending is the lending channel used least often for both retail and corporate SMEs in Serbia today. Banks are more cautious than before. This is due in large part to a high level of Non-Performing Loans (NPLs) following the 2007 financial crisis, from which banks were unable to recover the full value of the collateral backing up these loans.

That said, it would be misleading to state that collateral is not important. Banks are still “very likely” to request guarantees and collateral as a safeguard measure. Collateral is often required as part of credit risk mitigation, and the existence and value of collateral is used to determine loan pricing. It is also a standard practice for banks to ask SMEs owners to sign a personal letter of guarantee as part of the loan application. Under a personal letter of guarantee, the bank has access to the SME owner’s personal assets in case the latter fails to repay the loan. Banks stated however that this is used more as a psychological pressure, as personal letters of guarantee are very difficult to enforce in practice.

**Figure 2: Likelihood to request additional guarantees**

## 2. Most of the banks surveyed use credit scoring models for approving loans to smaller companies (i.e. SMEs classified as retail clients).

These credit scoring models weigh several criteria, including SMEs' profitability, liquidity, and financial and sectoral risks. The use of financial information in these scoring models is quite high and varies between thirty to seventy percent, depending on the bank surveyed. Banks are therefore highly dependent on the quality of SMEs' financial information.

Small business credit scoring is a transactions lending technology based on hard information about the SME and its owner (i.e. primarily personal consumer data, including personal income, debt, financial assets, and home ownership) obtained from the credit bureau. This is combined with data on the SME collected by the financial institution and in some cases from credit bureau and data aggregators.<sup>12</sup> The data are entered into a mathematical model, which yields a score or summary statistic for the loan. In some cases, financial institutions make underwriting decisions based on "rules," automatically accepting or rejecting based on the score (with some manual overrides). In other cases, the score is used with "discretion" in conjunction with information gathered using other lending technologies (Udell and Berger 2006).

<sup>12</sup> Data aggregation is a type of data and information mining process in which data is searched, gathered, and presented in a report-based, summarized format to achieve specific business objectives and/or conduct human analysis. Based on our discussions, two of the main data aggregators in Serbia are Cube and Bisnode, whose services are used by all the banks surveyed. Cube and Bisnode aggregate information from a number of sources, namely (i) the Serbian Business Registry (APR): 5-6 databases, including on movable collateral (ii) the National Bank of Serbia (NBS): 3-4 databases (on blocked accounts, promissory notes, etc.), (iii) courts (court cases against a company), (iv) Geodatical Institute (on real estate pledged as collateral).

**For retail SMEs, four out of the six banks interviewed in Serbia use an internal and/or proprietary credit scoring model for making loan decisions.**<sup>13</sup> This mechanical rating procedure significantly reduces transaction costs and speeds up credit decisions. The use of financial information in the proprietary scoring models is on average quite high and varies between 30% and 70% depending on the bank questioned. There is, therefore, a high dependency on the quality of financial information. While credit scoring is used by a majority of the surveyed banks, its importance to the credit approval decision varies from bank to bank and depends on the size of the firm assessed. For some banks, credit decisions are based on scoring models. For others, scoring is one of several parameters in the decision-making process. In two banks, scoring models are not used at all.

**For corporate SMEs (i.e. medium-sized enterprises), banks use a more conservative approach and rely less on automated credit risk appraisal techniques.** Only two banks surveyed report using credit-scoring models for medium-sized companies. In one of these banks, scoring is used for medium-sized companies only for granting loans up to a certain amount (i.e. EUR 50,000). The other bank's scoring model for medium-sized companies is only one of the criteria used in its loan assessment process.

**3. There are a number of SMEs for which banks have not yet developed an effective way to provide credit.**

These SMEs are too large to be assessed by scoring models but also too small to be financially worthwhile for banks to invest a considerable amount of time in relationship building.

Improvements in the quality of financial reporting of these companies would harness positive results for both the companies and their providers of external finance. These companies could benefit from having easier and more explanatory loan applications together with a template that would convey key financial information. Such a template would enhance the completeness, timeliness, and reliability of financial information submitted as part of the loan application. Banks would have a more complete financial picture of potential SME clients, including targeted information on business risks and profitability.

Furthermore, many of these companies are not subject to mandatory audit requirements (i.e. according to the Serbian Accounting Law, small companies—i.e., those with a turnover

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<sup>13</sup> In all the banks surveyed, the credit-scoring models used for micro and small companies were developed locally, in some cases with validation of the bank's head office. The models used by Serbian banks are both country and sector specific.

between EUR 700k and EUR 8,800,000—are not required to undergo an annual financial statement audit). The use of a limited assurance product to review key aspects of such companies' financial information could prove useful for them. This would be one step down from a full audit and, ideally, would be developed together with the accounting and audit profession, banks, SME associations and other relevant stakeholders.

As these companies have the potential to become the medium and large corporations of tomorrow, providing much-needed jobs and serving as an engine of growth for the economy, improving the financial capability of their owners at this stage is crucial for helping them grow. This could entail the development of a tool to help SMEs identify and express financing needs in line with their growth strategy.

#### 4. Weak SME financial management skills is the most significant obstacle to access financing, leading to delays in lending decisions and increases in the cost of finance.

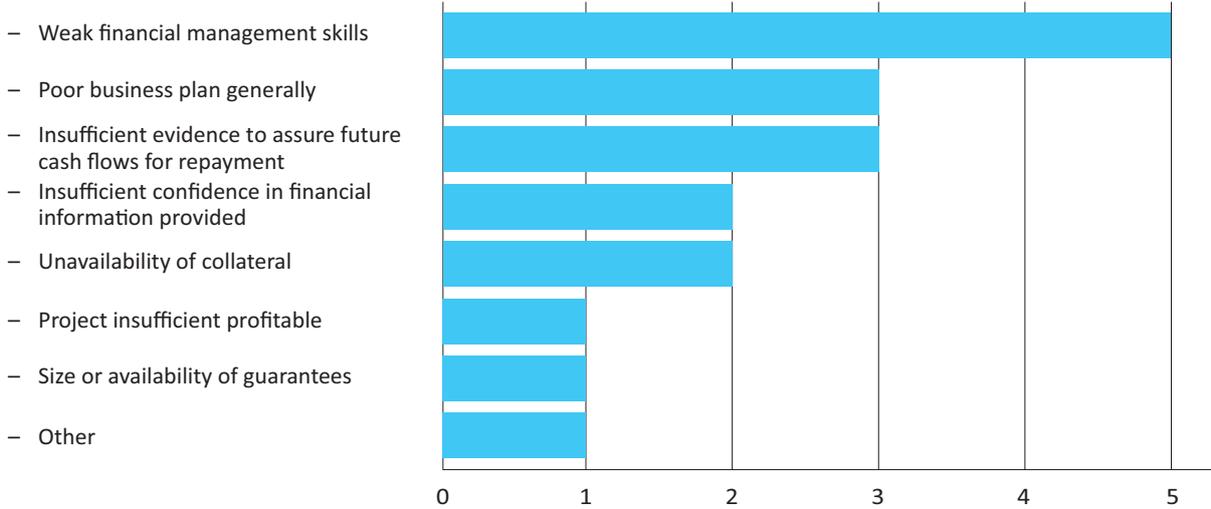
SMEs lack effective financial management skills, which constrains their ability to clearly identify and communicate their financing needs and to report their financial information reliably. Unrealistic business plans and assumptions require greater diligence on the part of loan officers, which leads to delays in the application process. Furthermore, SMEs may not use financing products efficiently, e.g. using working capital loans for investment purposes. Anecdotal evidence also suggests that there is an important “unexpressed demand” for external financing among SMEs (i.e. SMEs are not able to judge when and how much financing they need). The fact that about one-third of SMEs request loans to refinance their debt could be a further indication of their poor cash management abilities. As a result, several qualitative factors are used to initially screen and filter loan applications, taking into account the competencies and experience of SME owners, their payment history, number of years of activity in the sector, etc.

Five out of the six banks surveyed mentioned that weak financial management skills of SME owners is the biggest obstacle preventing the supply of loans to these companies. Three banks mentioned poor business plans as another significant obstacle.

**Another obstacle for banks lending to SMEs is the insufficiency of evidence to assure future SME cash flows for repayment.** According to the World Bank's Global Financial Development Report 2014, SMEs often do not have adequate records and accounts to document their past performance. This is exacerbated by SMEs' informality, which makes it extremely difficult for banks to forecast their future cash flows. Frequently an SME will perform well in the early

stages of their development and then grow beyond the owner’s capacity to manage it. Therefore, it is crucial for good financials to be associated with strategic planning, financial knowledge, and the willingness to seek outside professional support services as the firm grows.

**Figure 3: Obstacles to bank lending to SMEs**



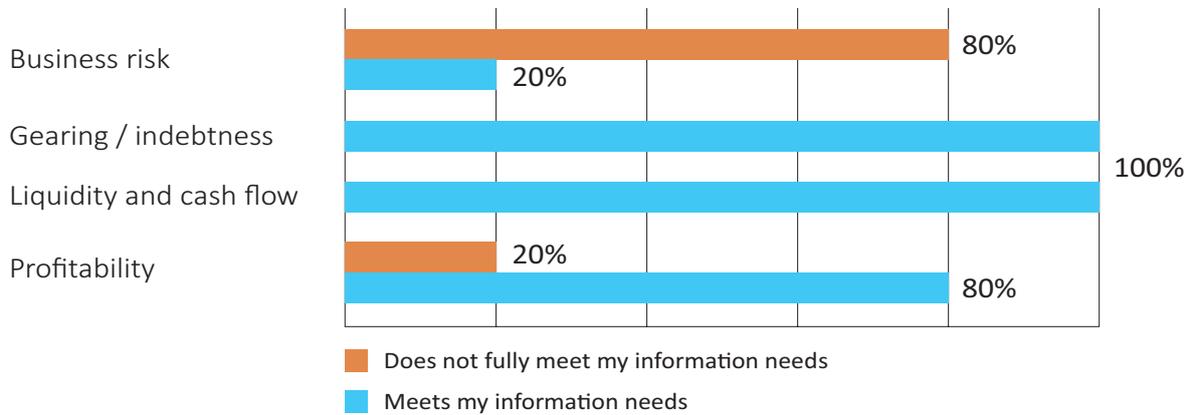
**Weak financial management is also the root cause of delays in the loan application process.** The presentation of unrealistic business plans and/or assumptions is a “very important” factor slowing down the application process. This factor is followed by banks’ internal administrative procedures. The banks also reported that unreliable financial information and incomplete application files have an “important” impact on processing times.

**Finally, business owners are not always able to convey their company’s strategy and express their financing needs.** Survey findings show, for example, that about one-third of SMEs requested loans for debt refinancing, one-third for investment in property, plants, and equipment (PPE), and the other third for acquisition of other companies. Banks noted that the high level of loans requested for debt refinancing purposes sometimes reflects SME owners’ poor cash management abilities, in that these companies regularly seek to extend their short-term debt. Banks further stated that SMEs use short-term and more expensive working capital loans for investment purposes. The problem of “unexpressed demand” and the maturity mismatch (i.e. between the loans granted and their intended purposes) can be improved by greater financial literacy.

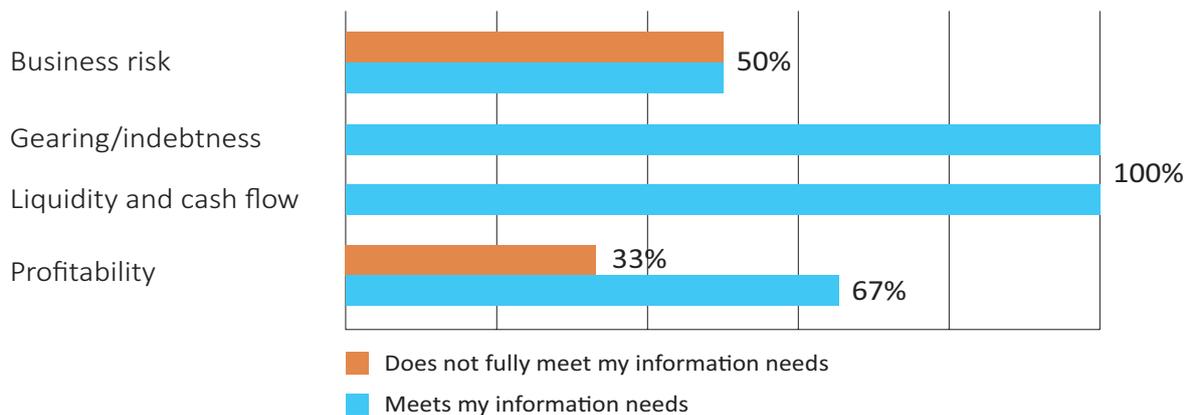
**5. Low reliability of financial statements and insufficient disclosures (particularly resulting from operations in the informal economy) make business risk and true profitability difficult to assess, further restricting access to credit and driving up costs.**

SMEs rarely present detailed information about the maturity structure of their receivables and payables, stocks, inventory, and unfinished products. SMEs' current portion of debt is often not separated from long-term debt, companies are not consolidated, and related party transactions go reported. This makes it difficult to understand companies' total indebtedness and dependencies. Consequently, business risk is difficult to assess. The importance of the informal economy is a major issue that affects the quality of financial statements, as figures reported in financial statements are not always reliable. Profit, for example, is typically underreported to avoid paying taxes.

**Figure 4: Evaluation of the information content of financial statements of SMEs classified as corporate clients**



**Figure 5: Evaluation of the information content of financial statements of SMEs classified as retail clients**



Lack of resources and capacity in the internal accounting function and earnings management are likely the root causes of many recurring accounting deficiencies (World Bank 2016).

**Our survey results show that banks are particularly dissatisfied with the quality of the information disclosed in financial statements on business risk and profitability, particularly for smaller companies.** The smaller the SME customer, the less transparency there is into its real profitability. Because so many smaller businesses operate in Serbia's significant informal economy, SMEs owners and managers tend to understate the level of profitability of their business. Typically, expenses are inflated to reduce profitability and, hence, tax payments.

**Banks further report that the notes to the financial statements are not detailed enough.** Some recurring issues include a lack of detail about the maturity structure of receivables and payables, stocks, inventory, and unfinished products. This information is key to understanding the business risk of a company. Furthermore, SMEs' current portion of long-term debt (CPLTD) is often recorded under long term liabilities. When reading a company's balance sheets, banks compare CPLTD to the company's current cash position to determine if a company has sufficient liquidity to pay off its short-term obligations and assess its risk of default.

**Another issue is the lack of disclosures on related party transactions, which makes it difficult to build a reliable picture of companies' total indebtedness and dependencies.** Knowledge of relationships and transactions with related parties is crucial to understanding where the control lies. Control impacts a company's strategy and its financial and operating policies. Related parties may enter transactions that unrelated parties would not consider, in particular because related parties may benefit from preferential treatment. Some banks are using a matrix software to match owners and their relatives to get a better understanding of the business and its related parties. Information from local relationship managers is also very important to banks in assessing SME business operations and risks.

## 6. Banks need up-to-date, periodic financial information but such information tends to be of poor quality.

A major obstacle to bank lending is the lack of timely and reliable interim financial information from SMEs. Annual financial statements are usually not sufficient for loan applications, and banks customarily request companies to submit up-to-date, interim financial information, including trial balances. Interim financial information provided by SMEs tends to be of poor quality and is often not presented clearly, which causes delays in the loan application process.

**Financial statements of SMEs in Serbia are publicly disclosed, consistent with European Union requirements.** The Serbian Business Registry Agency (APR) makes financial statements publicly available and easily accessible for all companies registered in Serbia. All companies are required to submit their annual and consolidated financial statements as of 31 December to the Agency by June 30 of each year. Users can access the full set of financial statements (i.e. balance sheet, income statement, statement of cash flow, statement on change of equity, statistical annex, and notes to the financial statements) of all companies on the Agency's website, free of charge. Financial statements are published on APR's webpage within 60 days of receipt, which make them available to banks with a delay of at least seven months after the closing of the financial year.

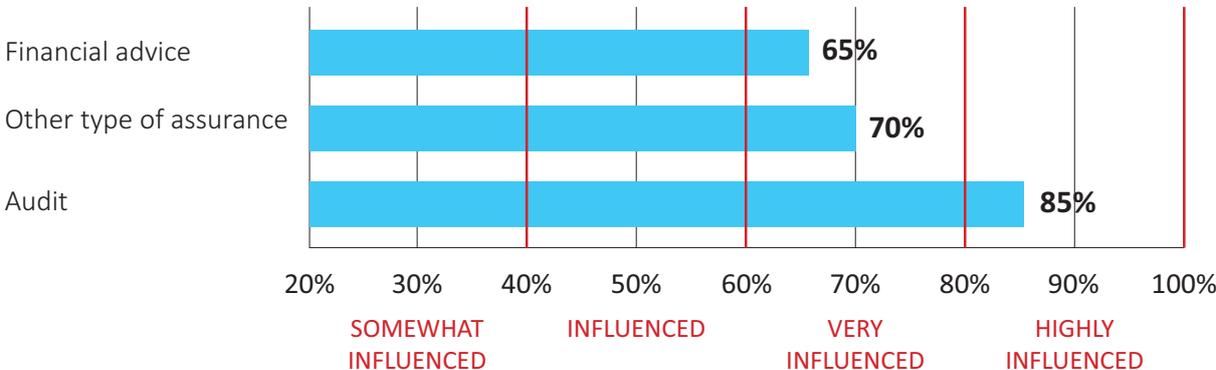
**Banks need up-to-date periodic financial information as part of the loan application process. Banks typically request SMEs to provide a trial balance statement that is no more than three months old with their loan applications.** One issue raised during follow-up interviews was the lack of comparability of these trial balance statements, which are not presented in a standardized or business-friendly format. Typically, SMEs have different accounting systems and software and will submit a printout from this software to banks directly. Because the presentation differs, bankers often must follow up with individual SMEs to understand the different line items in the trial balance. Furthermore, how this information is supported differs for each SME. Trial balance statements are submitted either as word documents, excel spreadsheets, screenshots, or PDF files. Some of these formats are not practical for banks because they must manually input the data into their systems. This process can take two weeks and is one of the major sources of delays in the SME credit application process.

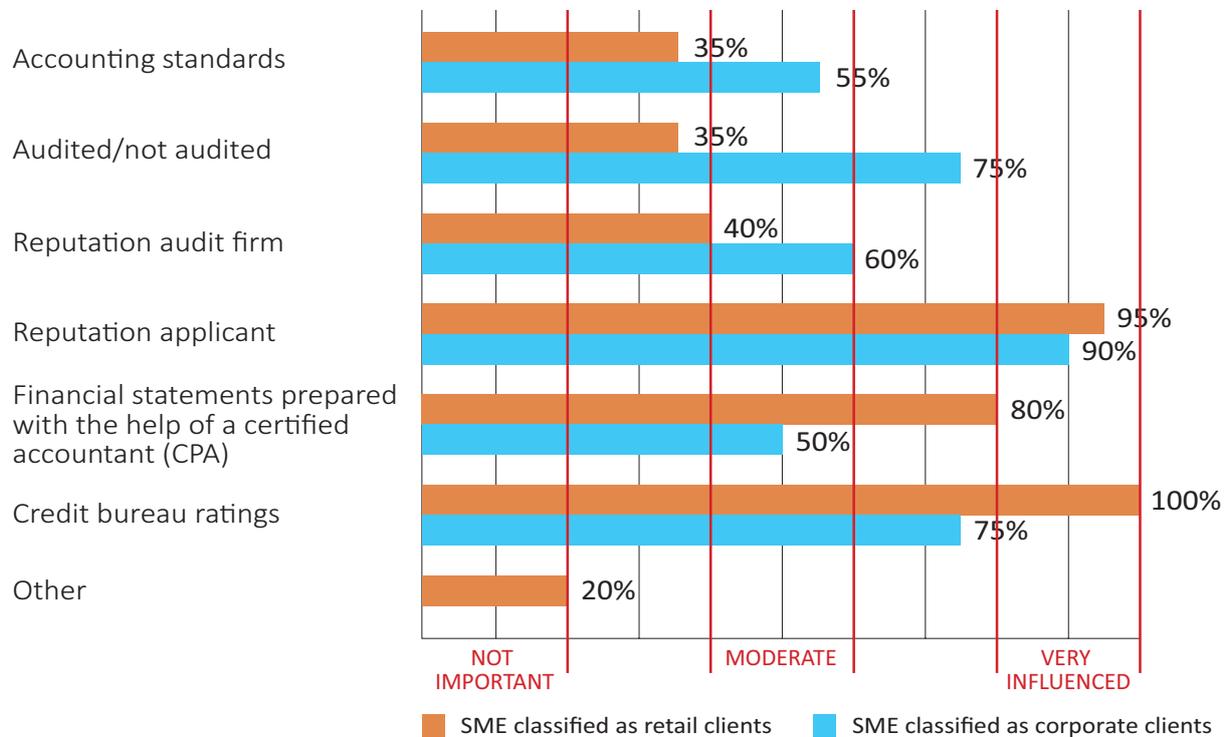
**7. All the banks interviewed see external audits as important for enhancing the reliability of information provided by SMEs; however too few audits are performed and their quality is uneven.**

Financial statement audits are only performed for medium and large-sized firms, which face a statutory audit requirement. According to the banks surveyed, less than five percent of companies provide audited financial statements on a voluntary basis (i.e. when it is not a legal requirement). Banks believe that they would be less competitive (time- and cost-wise) if they required audits for small companies. Furthermore, banks view the quality of audit services as uneven. The banks surveyed generally perceive the work of the local Big Four audit firms positively, but have concerns about the quality and independence of small and medium audit firms. Most SMEs try to minimize spending on accounting and auditing, with commensurate impact on quality.

**Banks take into account whether an accountant or auditor has provided services to the SME through an audit or other means.** An independent financial statement audit is considered an “important” factor in the credit decision. Furthermore, when considering extending credit to SMEs, banks are “highly influenced” by the fact that SMEs have engaged a certified public accountant (CPA) to provide audit services. This is especially true for smaller SMEs (classified as retail). Furthermore, banks are “very influenced” by whether a CPA has provided another type of assurance or financial advice. In practice, it is rare that SMEs hire a CPA to provide a limited assurance review or help compile their financial statements. This explains why financial statements reviewed by a CPA are “less important” and financial statements compiled by a CPA are the “least important” factors in the credit decision.

**Figure 6: Extent to which banks are influenced by SMEs’ retention of a professional CPA to provide**



**Figure 7: Indicators of the quality of financial statements**

**It is not customary for banks to request audited financial statements or any other type of independent assurance where this is not already a legal requirement.** Banks are concerned they might lose clients to other banks if they require smaller companies to present audited financial statements. This is not only an issue of imposing an additional cost on the client, but also an issue of time. Requiring an audit would delay the credit approval process. The surveyed banks stated that only a small (<5%) number of smaller companies undergo financial statement audits, as they have no legal obligation to do so.

**The reputation of the audit firm has a moderate impact on the perceived quality of financial statements for both SMEs classified as retail and corporate clients.** Banks do not have a high opinion of the quality of audits conducted in Serbia, with the exception of audits conducted by the Big Four. In specific cases, banks might request that financial statements be audited by one of the Big Four. This includes situations in which: the loan amount is considerable; there is a sudden change in accounting methods (for example a switch from Last In First Out (LIFO) to First In First Out (FIFO)); or when the bank credit officer has concerns about the correctness of a report.

**8. Overall, shortcomings in financial reporting quality and weak financial management skills of SMEs owners require more due diligence by banks. This is a costly and time-consuming exercise that slows down the loan application process, increases cost for SMEs, and contributes to bank reliance on collateral and guarantees to price loans.**

All the banks interviewed have created some form of internal controls to flag inconsistencies between SMEs' officially reported financial statements and the other information they provide. This extensive due diligence is necessary to address the lack of information about and the informality of SMEs' business practices. This time-consuming process is reflected in the interest rates paid by SMEs. Furthermore, banks are still very likely to rely on personal guarantees and collateral to support loan pricing.

Each bank surveyed has developed its own internal due diligence process to review the information provided as part of the loan application, including both quantitative and qualitative risk analyses. These due diligence processes are used to mitigate shortcomings in financial reporting quality and weak financial management skills of SMEs owners. **Quantitative assessments** are based on the financial statements provided and include an analysis of an SME's balance sheet structure, profitability, income sources, cash flows, liquidity, and solvency, among other items. Information from financial statements is then compared with the information provided as part of the credit application (i.e. business plans, bank account, and the owner's personal financial information). The **qualitative assessment** considers the competencies and experience of SME owners and managers, the quality of their corporate governance and succession planning, their payment history, their number of years of activity in the sector, and business competitiveness (products, demand, and market structure). Banks assess whether good financial statements are the result of luck or the owner's business skills. While the time spent on the due diligence process varies depending on the type, amount, and maturity of the loan (for instance, small working capital loans typically take less time to process), it is consistently a labor-intensive and, thus, costly exercise. It slows down the loan application process, impacts the costs paid by SMEs, and contributes to banks' reliance on collateral and guarantees to price loans.

## CONCLUSIONS

**This report shed lights on the importance and limitations of information from financial statements in the lending process in Serbia.** Analysis of our survey results shows that improvement in financial reporting quality could have significant positive effects on expanding access to credit for SMEs in Serbia. Improving accounting and financial competencies of SME owners is an essential component and could result in deeper structural changes needed to improve SME access to finance. Current shortcomings in financial reporting quality and weak financial management skills of SMEs owners require more due diligence on the part of banks, which becomes a costly and time-consuming exercise. Delays in the loan application process raise the cost of financing for SMEs and contribute to the reliance of creditors on collateral and guarantees to price loans. The findings of this study provide further incentives for SMEs, their accountants, and their auditors to cultivate a reputation for reliability, so that they can obtain favorable loans terms.

**All banks surveyed are also exploring ways to become more efficient.** Technological advancements, including better databases, telecommunications and connectivity, and software packages, are actively being explored to improve risk management techniques and loan processing time. Some key outstanding issues are:

- *The over-centralization of loan approval processes.* Half of the banks interviewed currently have a very centralized process for approving loans with credit decisions systematically taken at the credit institution's headquarters in Serbia. For the other half of the banks, the person who makes the final decision depends on the size and maturity of the loan, the client's credit rating, and the bank exposure to a client. Banks should explore ways to decentralize or streamline their lending procedures. This can be achieved by building the capacity of bank relationship managers to assess credit risk and approve small ticket loans directly at branches and or by using technologies such as online advisors.
- *The lack of proportionality with regard to loan documentation required.* Loan documentation required should be proportional to the size of the company and the risk taken by the bank. Some banks require the same level of detail for the loan applications of micro, small, and medium enterprises, regardless of the loan amount or credit terms or the fact that SMEs are very sensitive to loan delivery time and complex procedures. One potential policy action is to modify documentation requirements to allow banks more discretion in accepting different types of documentation from SMEs.
- *The suitability of banks' products and services.* Products specific to SMEs are usually standardized or packaged. Only one of the banks surveyed offers tailored products to SMEs based on their sector of activity (e.g. manufacturing, trade, transport and storage,

et al.) No banks report having specific products for SMEs based on business life cycle. Policy makers could provide non-financial incentives for banks to lend to underserved SME segments and to develop new products and services for SMEs. This could include tax deductions on certain expenses, for example.

**The surveyed banks agreed that raising the quality of financial management and financial reporting by SMEs in Serbia could have a significant and positive effect on expanding access to and lowering the costs of finance, particularly for companies that are too large to be assessed by scoring models, but also too small to be worthwhile to invest considerable time in relationship building.** Experience has shown that there is no silver bullet in addressing the challenges SMEs face to access finance. Rather than providing *the solution* to the financing gap, this study instead offers *one more solution* to assist in closing this gap. Improving financial capacity of SMEs is not a short-term endeavor. Such efforts, however, could bring about sustainable improvements in the medium to long term without distortionary effects to the market.

**The survey revealed some ideas for tools and concrete actions that could be undertaken to improve the quality of SME financial reporting and SME financing prospects.** Such improvements can help reduce the time and costs spent on banks' due diligence processes. They would also contribute to increased competition, improved access to finance, and quicker loan pricing, while reducing reliance on collateral and personal guarantees. Specific improvements include:

- ***Creation of a standard template to supplement loan applications to convey key financial information in a straightforward manner.*** Such a template will enhance the completeness, timeliness, and reliability of financial information submitted as part of the loan application. Banks would have a more complete financial picture of potential SMEs clients, including targeted information on business risks and profitability.
- ***Use of a limited assurance product to review key aspects of SME financial information.*** This would be one step down from a full audit, and ideally would be developed together with the audit profession. It will focus on key areas of weakness in current SME financial statements, e.g. account payables and receivables, inventory stocks, indebtedness, related party transactions, and profitability.
- ***Developing the capacity of SMEs to identify and express their financing needs in line with their growth strategy.*** In this regard, a special capacity-building exercise could be undertaken, focused on the specific business and finance needs of SMEs. Such an initiative would allow SMEs to readily identify competent service providers. This exercise could also serve to further the development and visibility of accounting professionals dedicated to serving the SME segment. Accountants with this special training could become advocates for SMEs and improve their communications with banks.

Besides the accounting profession, a potential partner for this exercise is the Chamber of Commerce (CoC) of Serbia, which already plans to provide counseling services and an online platform to train SMEs in financial literacy. In order to maximize the impact of financial literacy education, trainings should start with the validation of some very basic concepts and increase in complexity over time. It would be useful to assess participants' level of financial literacy both at the beginning and completion of the course and provide incentives for their completion.<sup>14</sup>

In some countries, financial institutions provide financial and business training to clients in an effort to improve the financial management and use of loans by these clients (see Box 2). Greater dialogue and knowledge sharing between SMEs and financial institutions should be promoted. Banks could organize more presentations to business associations, while the different Serbian Chambers could introduce banks' services and give presentations on financing constraints. The banking association could play a role as a technical resource to both banks and SMEs. Banks could provide feedback to SMEs on their loan applications, thus increasing the transparency of their credit policies and decisions.

In sum, financial literacy programs should raise awareness among SMEs on the importance of quality financial statements in obtaining external financing. For greater impact, these programs need to coordinate efforts from the National Bank of Serbia (NBS), CoC, and other institutions involved in financial literacy in Serbia.

### **Box 2: Insights from the World Bank's Global Financial Development Report on Financial Inclusion: Relevant Practices by Banks Worldwide<sup>15</sup>**

In some countries, banks have developed innovative strategies for lending to SMEs. In Argentina and Chile, for example, banks often seek out creditworthy SMEs through client relationships with large firms. They ask their large clients for references on their most dependable buyers and suppliers, which are SMEs in many cases. Banks in Argentina and Chile perceive the SME sector as large, unsaturated, and possessing of good prospects (de la Torre, Martínez Pería, and Schmukler 2010).

Another recent development is the banks in emerging markets are increasingly providing nonfinancial services to SMEs (IFC 2012). For example, banks offer training and consulting services that can improve recordkeeping by SMEs, thus permitting banks to

<sup>14</sup> Indeed, the World Bank's 2014 Global Financial Development Report states that financial management trainings lead to greater expertise, though the impacts on business practices and performance tend to be small depending on context and gender. This report further stipulates that, while the content of the training is very important, simple rule-of-thumb trainings sometimes have better results than standard business and accounting training.

<sup>15</sup> Source: World Bank 2014.

more easily assess the creditworthiness of these SMEs. In addition, a majority of these nonfinancial services are managed by SME account managers at banks, which allows banks to obtain detailed information about the business, its financial situation, and its banking needs. This business model reduces information asymmetry as banks gain more accurate information on SME loan applicants.

The Turkish Bank Türk Ekonomi Bankası is one such example. It has successfully used nonfinancial services to expand its SME lending. Starting in 2005, the bank developed and implemented training, consulting, and information-sharing services for SMEs with the goal of building a client base of healthy businesses, gaining new SME clients, promoting customer loyalty, and reducing credit risk in the SME sector.

While SMEs often lack sufficient technical knowledge and capacity to prepare sound financial statements, professional business development services can help to build capacity in this area. Two recent studies show that management consulting services can improve accounting and recordkeeping among SMEs (Bloom et al. 2013; Bruhn, Karlan, and Schoar 2013). Regulatory reforms that encourage informal firms to register with the authorities can also lead to better information on SMEs.

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