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# FACTORING AS A FINANCIAL ALTERNATIVE: EVIDENCE FROM SERBIA.

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Abstract. The paper develops and tests the hypotheses that explain the choice of factoring as a financing alternative and the profile of companies using it in the Republic of Serbia. The analysis is based on firm's demographic and financial characteristics such as age, turnover, industry, type of legal form and level of indebtedness. The analysis refers to a survey of 60 companies using factoring services. This research shows that the segmentation of firms using factoring is concentrated more on bigger firms, more than ten years old, limited liability companies in manufacturing and trade. We extend the research to the characteristics and prospects of the factoring industry in Serbia. We offer evidence that: (a) factoring is becoming more and more important as an instrument of short-term financing and cash-flow enhancement, (b) the legal environment is not favorable for factoring realization, and (c) this financial opportunity is not universally accessible among Serbian companies.

Key Words: factoring, financing, factor, market, determinant.

## 1. Introduction

Access to finance has been identified as a key factor of the companies to achieve and sustain financial competitiveness. Corporate practice shows that businesses face problems with regard to raising finance through regular bank borrowing, and to financing the gap between the timing of cash outflows and inflows. The problem of production cycle financing focuses many firms to find alternative forms of short-term financing for their operations.

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Factoring is a financial technique where a specialized firm (factor) purchases from the clients accounts receivables that result from the sales of goods or the provision of services to customers. In this way, the customer of the client firm becomes the debtor of the factor and has to fulfill its obligations towards the factor directly. The factoring agreement usually assumes that the whole credit risk as well as the collection of the accounts, are taken by the factor. Factoring offers enterprises, particulary small and medium ones, a means of financing their need for working capital, but also an instrument of collection of receivables and default risk hedging. Factoring is used in developed and developing countries around the world (table 1). According to the *Factors Chain International*, the world total stood at €1.648.229 million in 2010. The factoring industry endured the global financial crises much better than many other providers in the financial and insurance sectors.

The factoring market in Serbia has grow 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 millions 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.

In spite of a visibile development of the factoring market in Serbia, little academic work has been attempted to establish the role of factoring as a financial choice of Serbian companies. The studies on factoring in Serbia focus mainly on the legal aspects, such as informational, legal, tax and regulatory barriers to factoring growth (Kovacevic, 2005), necessity and the most appropriate varieties for the prospective factoring legislation (Milenkovic-Kerkovic, 2005), factoring as the obligation legal form of contractual party's changing (Milenkovic-Kerkovic, 2006), the role of assignment in factoring contracts (Spasić, 2009), factoring in the light of codification of Serbian civil law (Sulejić, 2008) as well as legal technique and environment for factoring contract in the Serbian legislation (Milenkovic-Kerkovic and Cvetkovic 2011). Jelenković and Milic (2010), as well as Maric-Scepanovic (2010) discuss the factors of the growth of the factoring business in Serbia. As an objective reason, Jelenković and Milic point to the lack of developed institutional and economic surrounding, while subjective reasons can be found in the lack of information on factoring, which leads to decision making as the least worst in a specific situation. Maric-Scepanovic (2010) empasises that the need for studies of factoring in Serbia arises from the growing problem of liquidity of domestic economic entities, which testifies to the increasing number of blocked accounts. She indicates that the removal of legal obstacles and grater affirmation of factoring could create the conditions for its rapid development and thus facilitate the flow of money and economic activity.

The evidence in this paper is presented in order to stress the imprortance of factoring industry in financial management of the Serbian companies. Since there have not been any undertakings to explain the type and profile of the companies using factoring on the Serbian market, the aim of this paper is twofold. Firstly, our intention is to give an overview of the Serbian factoring industry. In the second place, our aim is to explain the motivations for using factoring by analyzing the type of companies selecting it in terms of their demografic and financial characteristics (size, age, sectorial affiliation, organizational form, level of indebtedness).

**Table 1.** Total factoring volume in period 2005-2010 (in millions of EUR)

County/continent	2005	2006	2007	2008	2009	2010
Total Europe	612,488	806,983	932,269	888,533	876,649	1,045,069
France	81,600	100,009	121,660	135,000	128,182	153,252
Germany	45,000	72,000	89,000	106,000	96,200	129,536
Russia	1,130	8,550	15,100	16,150	8,580	12,163
UK	184,520	248,769	286,496	188,000	195,613	226,243
Croatia	28	340	1,100	2,100	2,450	2,793
Serbia	150	220	300	370	410	658
Total America	106,619	140,944	150,219	154,450	142,013	185,357
USA	81,860	960,000	97,000	100,000	88,500	95,000
Brazil	15,500	20,054	21,060	22,055	29,640	49,050
Total Africa	7,586	8,513	10,705	13,263	14,796	16,686
Total Asia	111,478	149,995	174,667	235,619	209,991	355,602
China	4,315	14,300	32,976	55,000	67,300	154,550
Japan	72,535	74,530	77,721	106,500	83,700	98,500
Total Australia	18,417	27,853	33,870	33,246	40,110	45,515
Total World	859,588	1,134,288	1,301,590	1,325,111	1,283,559	1,648,229
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Source: http://www.factors-chain.com (21.11.2011)

The paper is organized as follows. Section 2 briefly presents the features of the Serbian factoring industry. Section 3 explores the determinants of factoring and sets testable hypothesis, while in the next Section we present the data, descriptive statistic and basic findings. Section 5 provides some brief conclusions and directions for the future work.

## 2. FACTORING INDUSTRY IN THE REPUBLIC OF SERBIA

Factoring can be regarded as a relatively recent financial tool. Modern factoring industry was developed in the 1960s in the UK, primarily in the textile industry. As a financial instrument, the emergence of factoring in Serbia dates back to 2005, when Slovenian factor company *Prvi Faktor, faktoring d.o.Ljubljana* (the fist factoring company in Eastern Europe) established its subsidiary in Serbia *Prvi Faktor, faktoring d.o.o. Beograd.* Shortly after that, on the state level, a specialized institution *Fund for export business insurance and financing* (SMEKA) was constituted. SMEKA changed its name to AOFI – *The Export Credit and Insurance Agency of the Republic of Serbia.* AOFI operates nowadays as a specialized financial organization which performs financing and accounts receivable insurance for exporting companies.

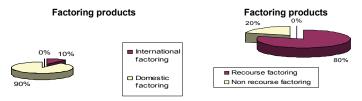
The new Law on banks<sup>1</sup> enacted in 2005 regulates that the banks can be involved in the deals of buying and selling accounts receivables (factoring and forfaiting). This measure has given incentives to many commercial banks in Serbia to be involved in the factoring business. According to the official data of the *Chambre of Commerce Belgrade*<sup>2</sup>, there are 10 registered factoring organizations that deal with factoring services and are

<sup>2</sup> www.kombeg.org.rs

<sup>&</sup>lt;sup>1</sup> The Law on Banks, Official Gazette of the Republic of Serbia, No. 107/2005 and 91/2010, Art.4

founded as independent financial institutions. According to the same source, there are also 7 factors which operate as specialized divisions or sectors of commercial banks. More relevant information on factoring is found in the data of the *Association of financial organizations*, the *Section for factoring development* within the *Chamber of Commerce Belgrade*. According to the report for 2010, in the Republic of Serbia there are 22 subjects registered for giving factoring services, organized as independant factoring companies or as integral sectors of commercial banks. Out of this number, 13 companies are very active or active in factoring activities, while the rest of the companies are in the phase of establishig or inaction.

Factoring companies and banks that participated actively on the factoring market in Serbia in 2010 are, among others: A faktor d.o.o., AOFI, Banka Intesa a.d., EFG Eurobank a.d., Finera faktoring d.o.o., GREX Factor d.o.o., JUBMES bank a.d, Marfin factors & forfaiters d.o.o, OTP banka a.d., Prvi faktor d.o.o., Raiffeisen banka a.d., Societe Generale banka a.d.. The total factoring turnover in the Republic of Serbia in 2010 reached €658 million, which represents a growth of over 60% compared to 2009. According to the *Association of financial organizations, Section for factoring development* data, the dominant share in the total factoring turnover is realized by "Prvi faktor d.o.o" Beograd (€238 million), "Banka Intesa a.d." (€ 110 million), "A faktor d.o.o." Beograd (€32 million), and "Raiffeisen bank a.d." (€13 million). Domestic factoring with recourse is the dominant form of factoring in Serbia (figure 1), which is a characteristic of all factoring industries in development (Reiffeisen Research publication, 2010).



**Fig. 1.** Factoring in Serbia Source: Belgrade Chamber of Commerce

The increase of the toatal factoring volume in Serbia is found to be a result of two factors: a) newcomers to the factoring industry<sup>3</sup>, and b) an affirmation of the factoring product on the market. If we take into account that this growth 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 recivebles as the colateral to acquire finance. The ongoing processes at the factoring market send positive signals for the future of this industry in Serbia.

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 im-

<sup>&</sup>lt;sup>3</sup> In 2010, EFG Eurobank a.d. started to provide factoring services, Komercijalna banka a.d. and Piraeus Bank a.d also announced the beginning of factoring projects in 2011.

pacts arise from increased service innovation, lower costs of factoring, improved accessibility to servicing smaller businesses, and finally, higher future factoring volumes.

The development of factoring in Serbia is obvious in spite of the unfovarable regulation environment. Factoring contract is not regulated in the Serbian Law of Obligation neighter in lex specialis. Moreover, the existing regulation does not recognize all aspects of factoring products, nor does it regulate factoring in a homogenous way and in detail. Court practices and executive procedure in Serbia are not efficient compared to court practices in the region and inefficient law and court system in Serbia and those facts directly influence the practice of discounting the bill of exchange as the main technique presented in the factoring business.

#### 3. DETERMINANTS OF FACTORING: HYPOTHESES DEVELOPMENT

The benefits and rationales behind the factoring decision have been studied in a large body of literature. One of the most often cited advantage of factoring is the improvement of financial competitiveness by the increase of liquidity and enhancement of cash-flow paterns of businesses. Companies are faced with liquidity risk, that is, with the risk that they would not be able to finance increases in assets and settle obligations at their expiration. In a volatile financial framework, factoring supports small and medium-sized firms to manage the required level of liquidity and offers them the advantage of obtaining further price discounts from suppliers.

There are at least two differences between factoring and bank credits that are in favour of factoring as a better financial alternative for small and young firms. In the first place, these two alternative tools of financing differ according to the type of collateral. In the case of factoring, accounts receivables (which are still non-realized assets) are used as collateral. This is highly important having in mind that small and medium companies often do not have sufficient assets to secure the loans. Secondly, the difference between factoring and bank loans is in the process of credit risk evaluation. While banks are interested in the credit analysis of the firm seeking the loan, factoring companies investigate the qualitative and quantitative characteristics of both the factoring client and its customer. Hence:

**Hypothesis 1**. Businesses using factoring are relatively small when assesing by turnover

**Hypothesis 2**. Factoring services have a tendency to be concentrated upon young, up to 5-year-old firms.

Factoring is widely accepted as an alternative financing source, and used in almost every industry that sells business-to-business or business-to-government. Industrialized economies are characterized by a substantial shift from the primary and secondary sectors to the tertiary (service) sector, which has occurred in the last 30 years. According to GLE Report (2004) factoring is most represented in the manufacturing, transport, distribution, trade, and service sector. Tegla (2005), on the other side, emphasise the importance of factoring service in agriculture sector in the Hungarian economy.

What makes factoring a favorable tool of financing of companies in the industry and service sector? Typically, firms from these sectors grow faster than their credit line and have little or no credit history. They tend to be payroll intensive and usually have little

proper collateral which can be used to secure traditional bank loans. Furthermore, the enterprises from industry and service sector are becoming more innovative and knowledge intensive, and have high investments in intangible assets. As a consequence, their financials statements do not reflect their real financial potential and often they can not qualify for conventional bank financing (GLE report, 2004, p. 36). Empirical research done by Soufani (2002) realized on the sample of the UK factoring industry also shows that the segmentation of firms using factoring is concentrated on companies in manufacturing, distribution and transportation. Therefore:

**Hypothesis 3**. Factoring services tend to concentrate on manufacturing and trade.

Legal form of the business is another determinant of factoring. Demirguc-Kunt et al. (2006) show that incorporated firms face lower obstacles to financing their growth and to use specific financial instruments such as factoring and leasing. Corporations report fewer financing, legal and regulatory difficilties than unincorporated firms and this advantage is greater in countries with more developed institutions and favorable business environments. With regard to legal form of business, survey of factoring in the EU countries (GLE report, 2004, p.41) shows that factors preferably choose clients which are registered as limited liability companies. Sole trader and partnerships are also accepted as suitable forms of legal forms. Study given by Soufani (2002) points that form the standpoint of legal form, factoring clients are mainly limited liability companies. Therefore:

**Hypothesis 4**. The use of factoring services is focused on limited liability companies.

Sopranzetti (1999) claims that factoring can be used as a tool for the underinvestment problem mitigation. He shows that the underinvestment problem is more serious for firms that have constraints on the use of debt in financing new projects (when the firm has maximally explored its debt capacity or in the case of financial distress). Sopranzetti demonstrates that under such circumstance firms are more motivated to sell their accounts receivable in order to lessen the underinvestment problem.

On the other side, the study by Smith and Schnucker (1994) concentrates on the complex relation between factoring, vertical integration, transaction costs and credit risk. Their opinion is that factoring is expected when the seller's cost of monitoring of customers is high, i.e., firms use factoring in order to hedge their credit risk. However, this conclusion is open to discussion, because of the fact that firms are usually the only ones able to sell their receivables of a highest quality. Soprazetti (1998) shows that when the factor can not assess the level of the seller's credit risk, a rational factor will assume the posibility of a moral hazard problem which will be comprised in the equilibrium price of the agreement. Sellers with a high bankruptcy risk may be able to only factor their highest credit quality receivables on a non-recourse basis. The medium quality receivables will have to be factored with recourse, while the lowest quality receivables will not be factored due to high costs of factoring. Therefore:

**Hypothesis 5.** The higher the level of indebtedness and the less the availability of credit by banks, the higher the usage of factoring.

## 4. DATA, DESCRIPTIVE STATISTIC AND BASIC FINDINGS

The results of the analysis are derived from the survey of the use of factoring services on the Serbian market in 2010 done by the inquiry. Our sample is comprised of 60 com-

panies using factoring as a financial source (the data for the companies is collected from various factors as supplies of factoring services). The main source of data for the sample firms is the information from the interviews done with factoring companies and from the *Serbian Business Registers Agency* (SBRA). For each company we obtain information about the turnover, age, sector, ownership, legal form and level of indebtedness. A descriptive statistic is presented in Table 2.

According to the size, the legal entities are classified into three categories: small, medium and big enterprises. As a criterion for the classification, we use realized turnover and the number of employees. According to the Law on accounting and auditing<sup>4</sup> (Article 7) all legal entities are classified into small ones (number of employees up to 50, average annual turnover up to 2,500,000 EUR or 263,746,000 RSD for the year 2010), medium (number of employees from 50 to 250, annual turnover from 2,500,000 EUR to 10,000,000 EUR or from 263,746,000 RSD to 1,054,882,000 RSD) and big legal entities (over 250 employees, annual turnover over 10,000,000 EUR or 1,054,882,000 RSD). With reference to the turnover sum, the size distribution is skewed towards larger businesses with neraly 57% of the respodent in the category over 1,054,882,000 RSD.

**Table 2.** Descriptive statistic of the selected firms using factoring services

	Number of firms	Share of the total number of	
		firms in the sample	
Size (Turnover)			
less than 263,746,000	16	26.67%	
263,746,000-1,054,882,000	10	16.67%	
over 1,054,882,000	34	56.67%	
Sector			
Agriculture	2	3.33%	
Manufacturing	27	45.00%	
Construction	5	8.33%	
Trade	21	35.00%	
Communications	2	3.33%	
Consulting	2	3.33%	
Other	1	1.67%	
Age			
less than 5 years	3	5.00%	
5-10 years	13	21.67%	
over 10 years	44	73.33%	
Legal form			
Joint stock company	13	21.67%	
Limited liability company	47	78.33%	
Level of indebtedness (total li	abilities/total assets)		
less than 40%	8	13.33%	
40%-80%	36	60.00%	
over 80%	16	26.67%	

<sup>&</sup>lt;sup>4</sup> Official Gazette of the Republic of Serbia, No. 46/06 and 111/09

The age distribution of the companies in the sample is skewed towards older businesses. The distribution is comprised of 5% of 5-year old companies, 21.67% of 5-10 years old companies, and 77.33% of companies that are more than 10 years old.

Opposite to the findings of Smith and Schnucker (1994) as well as of Soufani (2002), evidence from our survey suggests the smallest and young firms at the Serbian market rarely gain access to factoring financing. Factoring services are concentrated between bigger companies (turnover over 1,054,882,000 RSD) in the established and mature stage of the business life cycle.

Factors prefer clients with an established trading history, typically more than 5 years. The argument lying behind this observation is that the smallest and young companies would be excluded in the process of risk assessment of the factoring companies. These companies on the Serbian market are characterized by high risk due to the lack of expirience and the data, poor realtionships with the banks and non satisfactory level of asset needed to secure for the risk undertaken by the factor. In other words, factoring firms necessary have to perceive sufficient level of generated revenue by the client and longer existence on the market in order to offer their services to the clients. Therefore, our evidence indicates that *Hypothesis 1 and Hypothesis 2 are rejected*.

According to the sectorial segmentation, the evidence results imply a particular concentration of factoring services on the manufacturing and trade secotor (in sum, 80% of the responded companies). This could be explained by the characteristics of these companies in respect to customer base and invoicing procedures (Soufani, 2002), but also by the sectorial structure of the Serbian economy. Our evidence is consistent with the findings of the GLE Report on the use of factoring services within and among EU member countries, where factoring companies tend to exclude certain sectors from their portfolios. The dominant share of manufacturing and trade in the sectrorial distribution of factoring services is also in line with the sectorial structure of the Serbian economy. According to the Statistical Office of the Republic of Serbia<sup>5</sup>, in the structure of Serbia's GDP in the period 2001 - 2010, sectorial share of agriculture was 8%, industry - 19,6%, construction -3,7%, trade – 9,7%, transport and communications – 10,1%, financial intermediations – 3,4%, and so on. Even though the share of transport and communications in sectorial distribution is significant, these sectors do not participate proportionaly in the factoring supply due to characteristics of the sale contract (compexity) and stage payments. On the base of the above mentioned, we accept Hypothesis 3.

The population of selected firms using factoring are consisted of entities organized as limited liabilities companies and joint stock companies. The study shows a significant bias towards limited liability companies (over 78%). Hence, the factors operating on the Serbian financial market, preferably choose clients which are registered as limited liability companies, which is in consistency with the results of the above mentioned empirical studies. *Therefore, the fourth Hypothesis is accepted*.

With regard to the level of indebtedness as a determininat of factoring, we measure the firm's ability to repay its debt with the total debt ratio as a proportion of assets that is financed with debt – both short-term and long-term. The findings in the study show that, on the demand side of factoring services, there are companies with higer level of indebt-

<sup>&</sup>lt;sup>5</sup> http://webrzs.stat.gov.rs (1.12.2011)

edness, i.e. with a high level of financial risk exposure. The distrubiton of the companies according to the level of indebtedness is skewed towards highly indebted companies (total debt to assets ratio of more than 87% respondent is higher of 40%). The aviability of credit and higher requirements supplied by the banks, force highly indebdeted firms to turn to alternative financial sources to achieve a satisfactory level of liquidity and profitability. Since, there is a stong relation between the use of factoring and the existance of financial difficulties, and *Hypothesis 5* is accepted.

#### 5. CONCLUSIONS

The rise of factoring volume in Serbia in the previous 6-year period is obvious and in spite of the fact that factoring contract is the anonimous contract in Serbian commercial law. In order to improve efficiency of the factoring as the financial tool which increases the competitiveness of companies, legislation in Serbia should be adjusted especially in the sphere of company, tax, accounting and bankruptcy law, as well as the executive procedure regulation where factoring creates many of the legal gaps and uncertainity.

This study has built and examined hypotheses that explain the key determinants of factoring as the financing choice of companies in Serbia. Factoring in Serbia is specifically targeted and suitable for bigger and older businesses. The evidence supports the hypotheses presented in terms of sector affiliation and legal form. Factoring services tend to be concentrated on limited liability companies in manufacturing and trade. The findings are also to set up a relationship between the aviability of banking services and the factoring choice. The companies which typically select factoring as the financing option experience credit difficulties, have high value of indebtedness, and are likely to face financial difficulties.

At least two tasks are left to future research. In the first place, a complete analysis of factoring determinants should take into account the regression analysis of the selected variables, as well as a more representative sample of companies using factoring on the domestic market. Secondly, the list of demografic characteristics and financial variables determining the use of factoring by Serbian enterprises is not limited to the above selected variables. The shortage of cash and existance of liquidity problems lead to selecting factoring as a financial choice too. The ownership of the legal entities could also play a role in the process of sectiong factoring by companies operating on the Serbian market. We could expect that companies in the foreign ownership use factoring more frequently than domestic companies. Therefore, testing whether there exist relationships between the use of factoring and liquidity level and the ownership variable could be also conductive to setting a list of factoring determinants at the Serbian financial market.

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## FAKTORING KAO FINANSIJSKI IZBOR PREDZEĆA: STANJE U SRBIJI

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Autorke razvijaju i testiraju hipoteze koje objašnjavaju izbor faktoringa kao finansijske opcije i profil kompanija koje koriste faktoring u Republici Srbiji. Analiza se zasniva na demografskim i finansijskim karakteristikama preduzeća kao što su starost, ostvareni prihod, delatnost, pravna forma i nivo zaduženosti. Analiza bazira na uzorku koji čini 60 preduzeća koja koriste faktoring usluge. Istraživanje pokazuje da se ova finansijsku opcija vezuje za veća preduzeća, stara više od deset godina, iz sektora prerađivačke industrije i trgovine, organizovana kao društva sa ograničenom odgovornošću. Autorke pružaju i pregled karakteristika i perspektiva razvoja faktoring industrije u Republici Srbiji koji pokazuje da faktoring postaje sve značajniji instrument kratkoročnog finansiranja i upravljanja novčanim tokovima u preduzeću. Naglašeno je da faktoring nije podjednako dostupan svim kompanijama u Srbiji, ali i da regulatorno okruženje ne deluje podsticajno na razvoj faktoringa.

Ključne reči: faktoring, finansiranje, faktor, tržište, determinanta.