feasibility study

FOR ESTABLISHMENT OF

FACTORING

COMPANY

IN SERBIA
Acknowledgements:

While developing this study with its consultants’ team, SEED has interviewed a number of organizations and institutions that have provided important input data necessary for the factoring business modelling and analysis of different options of legal status of the Factoring Company. We have interviewed and had very useful discussions with numerous commercial banks representatives, representatives of the National Bank of Serbia, Association of Serbian Banks and Ministry of International Economic Relations Serbia.

SEED is grateful for the time, inputs and cooperativeness that these organizations and institutions and their representatives have provided during the research phase of the development of this Study.

Special thanks goes to our team of consultants; Mr. Dragan Vukovic and his substantive knowledge and contribution to our better understanding of banking and market potential issues facing factoring business in the country, and for adding value to overall Study, assuming the role of consulting editor; Mr. Milan Parivodic whose expertise and experience in the area of business law provided in-depth analyses of Serbia legal framework and recommendations with respect to having factoring business in place; and to Mr. Predrag Milosavljevic, whose input on taxation and accounting standards that influence the establishment and operations of potential factoring companies in Serbia was invaluable.
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A. Scope

The Project involves a comprehensive review of the environment for establishing factoring companies in Serbia. Besides working on a study on possibilities for establishing of factoring companies in Serbia, the consultant will look at the possibility to establish a single company that would serve demands of Serbia and Bosnia and Herzegovina. Consultants on the project will research, analyze, and draw conclusions and recommendations related to the legal environment amongst others. In particular, the SME sector will be investigated since the majority of factoring opportunities lies here and not in the moribund state-owned / socially owned sector. SEED will support consultants with on-the-ground legal advisers and through introduction to leading SMEs in the economy. The scope will include but not limited to the following:

1) General information about Serbia, esp. at it would relate to Factoring (not to exceed 1/3 of the report)
   a) Summary of the legal environment
   b) Summary of the taxation environment
   c) Summary of the banking environment
   d) Overview of Serbia banking systems
      i) Are there banks specifically strong in financing exports?
      ii) Serbia Banking Acts (incl. capital requirements, licensing process, F/X-regulations, other important regulations and requirements)
   e) Other relevant observations about Serbia as a business environment*

* IFC has made a large investment into the banking sector in Serbia. IBRD has concluded negotiations with Serbia government on a new credit to improve the business environment. Further respective information may be insufficient to be included here.

2) The Environment for Factoring in Serbia

   a) General
      i) Basic considerations regarding Factoring within Serbia financing system (incl. whether Factoring is considered as banking product, and implications)

   b) The Market
      i) Is there a potential market for export factoring in Serbia?
         1) Exports of consumer goods, with special focus on SME exporters (countries of destination, volume of these exports, current status of refinancing exports, export promotion by guarantees, profile of exporting companies, etc.)
         2) How are exports being financed now (banks, L/C’s, subsidised lending for exports etc)?
(3) How are exports guaranteed now (Insurance companies, "IMPEX" organisation etc)?

ii) Is there a potential market for domestic factoring in Serbia?
   (1) How SMEs finance their receivables right now (prepayments by buyers, bank lending, other)?
   (2) Can factoring supplant expensive and hard to obtain revolving credits, which currently finance the bulk of SME working capital?
   (3) Are there mechanisms to secure payments (insurance, bank guarantee, bill of exchange)?

iii) The buyers’ market:
   (1) What is the structure of buyers for the potential products (consumer good): international chains v. "mama+papa" shop?
   (2) What are the payment terms in consumer goods in the different buyer groups?
      (a) How are invoices being collected?

(iv) Marketing
   (1) What is the likelihood for Serbia market to accept the “Factoring” product?
   (2) How to promote the Factoring product?

(v) Describe the development of Factoring markets in comparative countries in the first 3 years, and compare to the outlook for Serbia.

c) Legal Issues
   i) What legal requirements are necessary in order to have Factoring in place?
      Compare to the situation in Serbia
   ii) Legal status of factoring companies (bank versus trading company)
   iii) Impact of the legal status (different capital requirements, license, management requirements, FX regulations within the financial services industry, etc.)
   iv) Is there a legal framework that makes the product “Factoring” possible?
   v) Is there a legal framework which influences the product “Factoring” (e.g. FX-regulations)
   vi) Describe the FX-regulations influencing the Factoring business (keeping accounts in FX, refinancing in FX, etc.)
   vii) How can receivables be assigned?
   viii) Is there any prohibition of assignment of receivables?
   ix) How can receivables be collected (general rules, legal procedures, etc.)?
   x) Other relevant legal issues

d) Tax Issues
   i) Is there a tax framework that influences Factoring?
   ii) What is the tax treatment of Factoring in Serbia? How does this compare to best practices?
   iii) Describe and analyse any transaction-based and/or other fees
   iv) Other relevant tax issues

e) Accounting Issues
   i) What accounting regulations are applicable for Factoring? Compare to IAS
   ii) What is the accounting treatment for the factor? Compare to IAS
   iii) What is the accounting treatment for the customer? Compare to IAS
   iv) Other relevant accounting issues.
f) **Other Issues**  
Other relevant issues related to the environment for Factoring in Serbia

3) **Summary, Comparison, Analysis and Recommendations**

a) **Summary of the current situation (legal, tax, accounting, market) in Serbia versus the situation in countries with a developed factoring market.** Outline variances from best practices and provide related recommendation. Recommendations provided will be structured as follows:
   1. immediate importance
   2. near-term importance
   3. long-term importance

b) **What is necessary to be done in order to create Factoring as a financing opportunity within Serbia?**

**B. Deliverables:**

1) Periodic written and verbal updates during the whole process (via e-mail, facsimile or phone);
2) Summary of recommendations of necessary legal changes;
3) An analysis of the financial sector, legal and regulatory environment, and potential market of the factoring product in Serbia and Serbian that identifies key obstacles to the establishment of a factoring company;
4) A financial forecast for a Serbia and Serbian factoring company;
5) A business plan for a Serbia and Serbian factoring company;
6) A written report containing the information outlined in this proposal (in English language); draft report to be provided to SEED and IFC for comment;
7) Summary Report for the Serbian and Serbia Governments, satisfactory to SEED and IFC, outlining the study’s findings, listing needed changes to the regulatory environment (indicating the bases of the recommended changes)
8) One-day workshop in Belgrade for stakeholders, including preparation of materials.

**D. Reporting:**

International consultant and local consultants on the team were reporting to Mr. Davorin Pavelic, Senior Analyst and Ms. Azra Delalic, Program Asst. of Private Sector Development Team (PSD), but they worked with all team staff as appropriate in order to accomplish above-listed tasks.
1 EXECUTIVE SUMMARY

The purpose of this Study prepared by the SEED is to express the views on the issue of prospects for the development of factoring in Serbia and establishment of a Factoring Company in Serbia.

The Study has three main areas in focus. The first is to present the economic environment in Serbia and need for alternative financial support to the real economy sector. The second objective is to focus attention on the legal issues relevant for the development of the factoring commercial and financial activities as well as the organizational and regulatory aspects of the new entrants in the financial and commercial markets providing such activities. The third objective is focusing on the accounting and tax issues.

All of the three parts of the Study are pointing out the good prospects for the development of factoring in Serbia provided some of the impediments inherent in the existing legal and regulatory fabric are removed and the factoring concept is properly regulated. Such an opinion calls for immediate and across the table approach in addressing the relevant issues, so as to arm the national economy with yet another mighty financial tool for achieving the necessary high level of exports and economic growth after years of decline and stagnation.

To that end each of the three parts contains recommendations in respect of the major issues covered addressed to the interested parties.

1.1 The Environment for Factoring in Serbia

Banking sector being the backbone of the financial sector has been receiving special attention by the reform approach of the government as the Rehabilitation and Reconstructing of the banking sector is ranking among three top priorities of the basic economic aims, together with Fiscal Reform and Privatisation.

After the major political change in October 2000 the Rehabilitation and Restructuring of the banking sector in Serbia has had four stages. The current stage is the fourth stage and it indicates that the banking system in Serbia is still in the making as 19 banks should be recapitalized by, most certainly, foreign strategic partners, with other banks outside of the group also looking for strategic partners from abroad or for mergers and acquisitions in order to surmount the problem of maintaining the minimum capital requirements.

With such a predicament the banks in Serbia are yet to develop proper market activities and the financial market will only in a foreseeable future benefit from wider range of banking products and sophisticated services.

On the other hand SMEs, the long recognized sector of real economy harbouring the outlooks for overall economic growth still does not receive adequate attention in the statistical coverage. The track record of various sectors of industry are not broken down to reveal the SMEs performance.

The foreign lenders are extending their support by way of international credit lines available to the SMEs sector through the local banks chosen to be on-lenders or administrators and guarantors. However the SMEs face constant lack of working capital.

Strong need of companies in Serbia specially SMEs, for alternative financial support, is based:

- on the twelve years old chronic problem of insufficient working capital and
- on an inadequate bank credit support.

The above situation indicates the prospects for the factoring market in Serbia together with other opportunities that have already been materialized in the light of monetary stability and adequate initial legal framework.
Foreign factoring companies are necessary on the Serbian market. So, it is highly recommended to form a joint venture between an interested local bank and an experienced European factoring company. A participation of IFC in the share capital should be welcomed. Campaign should be started to get the support from the authorities, to regulate the factoring business, specially in defining factoring companies as "financial institutions". The market participants have to be regulated and supervised, so that the proper prudential and other requirements securing the health of the markets can be in place, i.e. minimal capital requirements they will have to maintain and the business standards they must observe. Preference of establishing factoring companies does not exclude bank operating a factoring in-house unit. The parallel presence of these two options is necessary and possible, not only because of the volume of demand for factoring service but also because of possibility for complementary operations.

1.2 Legal Issues

Factoring as a commercial service is based on factoring contracts. The UNIDROIT Convention on International Factoring (Ottawa, 28 May 1988) regulates the particularities of factoring relationship. The Convention on International Factoring should be ratified by Serbia and Montenegro, as its prime business partners have ratified it as well. Factoring contract is not regulated as a nominated contract in the Serbian and Montenegrin legal system. The only piece of legislation in Serbia and Montenegro which only mentions the term «factoring» is the Law on Prevention of Money Laundering. Law Obligational Relations (LOR) provides a solid contractual framework for assignment of receivables which is essential to factoring. Provisions of LOR on assignment of receivables do regulate general assignment of receivables well. A master factoring agreement can be stipulated. LOR provisions however do not regulate particularities of the factoring relationship needed by factoring business. The factoring contract can regulate particularities of the factoring relationship.

Business community, courts, tax authorities and other administrative bodies are not familiar with the factoring relationship and need guidance.

A law on factoring would be more authoritative than factoring contracts before courts and administrative bodies, and it would unify their approach to factoring from the outset. This law should inter alia regulate the relationship aspects based on the approach taken by the Convention on International Factoring. Beginners mistakes would thereby be avoided in the interpretation of contracts and the transaction in general by courts, Foreign Currency Inspection, National Bank and tax authorities. For this same reason leasing is regulated in a special Law on Leasing although leasing could have been operated based on leasing contracts only. It would be easier to introduce factoring business into Serbia if a law on factoring were in place, although factoring operations could be started on solid legal grounds before enactment of such law.

It is essential for factoring business, in case of debtor default, to have an efficient system of court ordered collection of receivables. Our courts act on basis of the Law on Execution Procedure (2000) which does not provide for an efficient collection procedure and needs to be revised to make it more impactful for the creditor. Normally, the creditor has to obtain a final judgment in civil trial procedure, and then based on it, to pursue the execution procedure until collection is effected. To overcome this slow procedure an inefficient summary execution procedure is regulated in the Law on Execution procedure. The great drawback of this procedure is that if the

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1 Ministry of Finance, Ministry of International Economic Relations, National Bank of Serbia
defaulting debtor raises an exception against the plaintiffs “veritable document”, challenging its debt on any grounds - even without producing any evidence for its assertions - the court will automatically refer the matter to be resolved in an civil trial procedure, which brings us to the regular slow collection process.

It is obvious that the Law on Execution Procedure needs amendment to make it more effective for the creditor by introducing the so-called «documentary procedure».

Generally the courts are weak and need to be empowered.

Foreign Exchange Operations Law and related legislation should not be problematic for operating factoring in Serbia. Foreign exchange interests of the state are not in any way imperilled by factoring. However, as factoring is a new concept to the entities involved (National Bank, Foreign Exchange Inspectorate, tax authorities) an understanding has to be reached with these bodies and adequate accounting and reporting techniques developed in detail, so as to make the operation function smoothly. For this work specialist legal advice is critical.

Banks are the only kind of institution under National Bank control adequate for operating factoring business. Nevertheless, factoring not being their core business should be limited to their select clients. Chinese walls should be installed to minimize conflict of interests. Due to the specificities of factoring business, it appears commendable that a factoring entity should have factoring as its core business. Therefore it is better for a bank to establish its subsidiary factoring company, which would benefit from the access to capital, but be a self-standing entity, not being exposed to conflict of interest limitations.

Due to the capacity of joint-stock companies to attract larger capital that this corporate form should primarily be used for factoring companies, and this should be regulated in the Law on Factoring to be adopted. The Factoring Law should provide that factoring joint-stocks companies should have a minimum pecuniary invested capital of US $200,000 for domestic factoring, while for operating abroad the minimum pecuniary invested capital should be US $2,000,000 (International Factor Chain standard). This to ensure the solidity of factors and thereby the reputation of the factoring industry in general.

Foreign branch offices would be a good option for export factoring, but they do not exist under Serbian law. Neither the Law on Companies nor the Law on Foreign Investment regulate foreign branches. Only representative offices can be opened, but they cannot do business. This situation has to change, as all European countries and the US are familiar with the concept of a foreign branch operation as cross border extension of foreign legal entity. Based on the above it is recommended to:

1. **Sign and ratify the UNIDROIT Convention on International Factoring.**
2. **Use joint-stock companies as the prime vehicle for introduction of factoring in Serbia.**
3. **Draft and adopt a Law on Factoring which shall regulate:**
   - Factoring contract relationship in line with the UNIDROIT Convention;
   - Special requirements for banks and companies doing factoring in the country and abroad (minimum capital, et alia);
   - Position of factor in bankruptcy procedure;
   - Insurance requirements;
   - Summary «documentary procedure» for fast collection of debts if the Law on Execution procedure is not amended.
4. **Draft and adopt amendments to the Law on Execution Procedure by introducing the summary «documentary procedure» for fast collection of debts.**
5. **Introduce foreign branch offices in the new Law on Commercial Companies.**
1.3 Accounting and Tax Issues

1.3.1 Legal Framework for Accounting

Accounting requirements in the Republic of Serbia are prescribed by the Federal Law on Accounting and Auditing, enacted in December 2002 and effective as of 1st January 2003. Republic of Montenegro has, however, enacted its own Law on Accounting, effective as of 1st January 2003.

The Federal Law on Accounting and Auditing, applicable in Serbia, adopts International Accounting Standards as national standards. All companies are divided into three groups by their size and this classification is crucial for determining the implications of the new Law on Accounting and Auditing. International Accounting Standards are obligatory for banks and financial organisations as of 1st January 2003, for large companies as of 1st January 2004, and for medium and small size companies as of 1st January 2005.

In Montenegro as of 1st January 2003, 18 of the International Accounting Standards are obligatory for all legal entities.

1.3.2 Accounting Treatment of Factoring

None of the laws specifically prescribe the accounting treatment applicable for factoring, as such transactions are not widely spread in Serbia and Montenegro. The accounting treatment that can be applied is the one that is usually applied for the assignment of receivables.

The accounting treatment of factoring, at the time being, is dependent on whether the factor is a bank or a company. If it is a bank, than as of 1st January 2003 International Accounting Standards apply. If the factor is a company, than in 2003, the accounting policies and standards identified in the previous Law on Accounting apply.

Major differences between the accounting standards prescribed by the previous Law on Accounting, that is in 2003 still applicable for large companies, and in 2004 for medium and small size companies, and International Accounting Standards with regard to factoring are IAS 36 “Impairment of Assets”; IAS 32 and 39 “Financial Instruments” as fair value of financial assets and liabilities is not determined; and IAS 12 “Income Taxes” as no deferred tax assets or liabilities are recognized.

The Law on Payment Operations, effective as of 1st January 2003, permits settlement of mutual money obligations by agreeing to substitute the creditor, i.e. debtor within a particular debenture relation (assignment, cession) or by a set-off (compensation).

1.3.3 Tax Issues

Tax laws do not stipulate factoring in any specific way. As of 1st April 2003, VAT is applicable in Montenegro however VAT is still not applicable in Serbia. Its introduction in Serbia is expected as of January 2004.

Currently there are three taxes that may affect factoring in Serbia:

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales tax</td>
<td>Factoring commission will be taxed at the rate of 20%. Interest on advances will not be taxed since such interest is exempt from taxation in Serbia. Every assignment of receivable as well as any and all further payments will be effected by this tax. Tax rate is 0, 22% of the amount figuring in money order, contract or other instrument.</td>
</tr>
<tr>
<td>Tax on financial transactions</td>
<td>The amounts of excises are adjusted on quarterly basis in line with the evolution of the retail price index.</td>
</tr>
<tr>
<td>Excise duties</td>
<td></td>
</tr>
</tbody>
</table>
2 ECONOMIC ENVIRONMENT

2.1 Introduction

The economic development in Serbia during the nineties suffered severely from the multiyear isolation, especially from the embargo imposed by the UN. The economic output decreased to less than 50% of what it had been in the early 1990s. High unemployment rates, hyperinflation, insolvent banks and insolvent business sector characterized the situation.

However after the political change in October 2000, with the support of the international community, Serbia succeeded in stabilizing its economy. The GDP growth-rates changed from -17.7% in 1999 to +6.4% in 2000 and to +6.2% in 2001. Estimation for 2002 and forecast for 2003 is on the level of +4%.

Inflation was also brought under control from a high 91% in 2001 to an estimated 19.5% in 2002, with forecast of 11% for the year 2003.

After a decade of stagnation one can expect the economic renewal. Basis for the renewal is restructuring the economy into a market-economy by means of privatisation and integration in the global economy.

An important prerequisite for the international reintegration of Serbia, was to resolve the problem of its foreign debts. In November 2001 FR Yugoslavia concluded an agreement with the World Bank on rescheduling its debts. At the end of 2001 an agreement was concluded with the Paris Club, who agreed to write off 66% of the debt. A similar arrangement with the London Club is under negotiation.

Another important task for Serbia is to rebuild the international trade relations. In the meantime, foreign trade is benefiting from autonomous preferential treatment in trade (no quotas, dismantling of tariffs) from the EU. Serbia's free trade agreements with Russia and Hungary are already increasing foreign trade.

While the economic environment offers domestic and foreign investors the same opportunities and possibilities, so far, foreign investors have been slow in discovering this country as an investment market. Total foreign investment in Serbia amounted to only EUR 1.3 billion at the end of 2001. The recent trend has been encouraging. In 2001 the inflow of foreign direct investment totalled EUR 160 million, nearly triple what it had been the year before. Investors from 66 countries invested money in Serbia.

Despite domestic political tensions, the economic reforms implemented so far and the progress made – particularly in privatisation - have been impressive. However, these efforts have not yet yielded the desired results.
2.2 The Financial Market Environment – Rehabilitation and the Strategy of restructuring Banking Sector in Serbia

2.2.1 An Overview
Authoritarian rule in Yugoslavia during 1990s, an environment marked by war, political and economical isolation, and financial chaos culminating in the highest inflation in modern history, all brought Serbian banks into an extremely difficult position. Macro-economic decline combined with the factors specific to banks and enterprises, manifested itself in general deterioration of banks loan portfolio quality, but also created a general state of Serbian banking sector at the end of 2000:
Banks couldn't adequately meet the requirements of households and enterprises in rendering credit services and mobilizing funds.
They were overburdened by impaired loans.
Their activities made their financial problems grow and continue to exhaust the economy; they maintained high interest rates and fought for their own liquidity that way.
They had not developed risk management methods, nor had they based their operations on prudential standards.

2.2.2 Economic Objectives
Regarding the overall situation, three basic economic goals of the newly elected government in 2001 were: bank rehabilitation, fiscal reform and privatisation. The experience of other countries in transition proves the extraordinary significance of addressing these issues from the very outset of the transition process.
Eighty three Serbian commercial banks were subject to rehabilitation and restructuring. This process did not encompass the banks from Kosovo and Montenegro. Since 1st January 2001 all those banks had an operating license issued by NBY, which exercises supervision and monitoring over them.
The strategy of rehabilitation and restructuring of Serbian banking has been defined by the NBY’s Program - Strategy of banking sector restructuring, and has been realized in the last two years.

The Program contains four stages:
1. Action preparations (January to June 2001) - general auditing of the banking sector - engagement of the respectable auditing firms Ernst & Young and KPMG/Barents;
2. National Bank of Yugoslavia action (June to September 2001) - bank classification based on the criteria of solvency and liquidity, followed by the process of merging and licenses revoking;
3. The beginning of Bank Rehabilitation Agency action (July 2001 to March 2002), started with nine banks being placed under the BRA management;

2.2.3 Rehabilitation
Through radically undertaken banking industry reforms during 2001, preparing it for the restructuring process in the 2002, one of the highest priority of the economic policy has been achieved – the conditions for rebuilding public confidence in the banking sector.
At the very beginning of the reforms process\(^2\) in the 2001, all the banks were:

- Reviewed by NBY applying some basic criteria (financial standing, quality of overall management, profitability, liquidity, regional importance, total cost of rehabilitation);

\(^2\) The first and the second stage of the NBY programme
Then placed into one of the following categories: solvent banks, liquid banks but not enough capitalized (within the NBY - Problematic banks division) and problematic banks (Bank Rehabilitation Agency – rehabilitation/stabilization or liquidation/bankruptcy).

The crucial part of the process was the estimation of financial standing of the banks, through radically undertaken process of balance asset classification and balance sheet cleaning of the nonperforming loans. A huge amount of provisions for possible losses and write-offs resulted with enormously high net loss in the financial statement of the banking sector at the end of the 2001. (Table 1, column 3), also with the loss of the core capital (Table 2, column 3).

Analytical approach to the unfavourable financial statement of the Serbian banking sector in 2001. shows that net loss in the financial statements of nine banks under the management of BRA accounted for 99.0% of the banking sector net loss as whole.

Before the end of the third stage of the Program, some banks were merged in order to attain the prescribed minimum of capital adequacy, many of them had their licenses revoked, including the four biggest Yugoslav banks bankruptcies.

Through different processes in the reform 2001 (mergers and acquisitions, liquidations), the number of banks in Serbia fell from 83 at the beginning of 2001, to 52 at the end of the same year. In 2002 the number of banks, including 3 banks in Kosovo and Metohia, was 51.

Extremely lower net loss in the financial statement of the banking sector during the first half of 2002 resulted:

- Mostly from the fact that four biggest banks under the management of BRA were liquidated at the very beginning of the 2002. The losses in financial statements of those four banks had accounted for 95.0% of the overall banking sector net loss in 2001.
- Also from the new orientation in business policy of the banks – now as a profit oriented financial organizations, estimating carefully credit and other business risks.

Stabilization and reform processes in the financial sector in 2001 and in 2002, specially marked by the privatisation and the final cleaning of risk items from the banks’ balance sheets, were not complemented with the rehabilitation of the enterprises-debtors, so that the real sector of economy entered 2002 with losses and structural imbalances. That resulted in maintaining the local enterprises highly risky partners of the commercial banks.

So, the deterioration of the financial results in the Serbian banking sector in the second half of 2002 confirms the above conclusions in that the two major causes of the reported losses are:

- the process of the final cleaning of the risk items from the banks’ balance sheets (expenses growth in the form of the charges in the banks’ balance sheets for the overall amount of the “old” FX savings, regardless of reprogramming the maturities, as well as the growth of extraordinary write-offs of claims against the end users of the Paris Club credits) and
- continuing presence of high credit risk in the new banks’ placements.

The two factors caused enormous rise of both extraordinary expenses and provisioning for contingent losses, so that these expenses affected the overall financial results of the entire banking sector in 2002 (Table 1, column 5).

Reported nett loss in the annual financial statements of the Serbian banking sector for the period I-XII 2002, amounts to EUR 442.8 mios and is 12.8 times higher than the nett loss reported for the period I-IX 2002 (EUR 39.6 mios).
The structural approach to the unfavourable financial result indicates the causes of the total loss in a surge of the extraordinary expenses (direct and indirect write-offs – EUR 617.3 mios) that in the second half of 2002 rose for 486%, as well as the provisioning expenses (EUR 333.3 mios), being the second item in terms of the size, based on dynamic rise in the third (237%) and fourth (240%) quarters of 2002.

Related to the above described increase of two groups of expenses, the net losses in sub-balances of extraordinary and off-business incomes and expenses (EUR 445.7 mios) and provisioning incomes and expenses (EUR 78.2 mios) were the main causes of the unfavourable results in the income statement of the Serbian banking sector for 2002. Despite the nett loss in the financial statements, Banks’ balance sheets as of 31.12.2002 picture soundness in terms of striking balance between the dinar and the FX sub-balances, as well as the satisfactory maturity matching of sources and placements, opening space for the liquidity.

Better quality of the banking sector consolidated balance sheet as of the 31 December 2002 (Table 2, column 5) is mostly the result of banking reforms in 2002, even though:

- The share of total capital (20.0%) and equity capital (25.5%) in the total balance liability is still insufficient (total capital is lower than the equity capital at the end of 2002, as well as the share in the total balance liability, because of the write-offs), and
- The amount of balance asset is for 55.0% lower compared to the same balance item in 2001 (the above mentioned liquidation of four biggest banks in Yugoslavia at the beginning of 2002).

The nominal decrease in value of the capital EUR 992.2 mios, as of 31 December 2002, as well as the decrease of capital in the liabilities from 26.1% at the end of September 2002 down to 20.0% at the end of December 2002, resulted from the mentioned processes aimed at the final cleaning from the banks’ balance sheets of various risk items (write-offs). This implies that the strengthening of the capital base in the coming years has to be the major objective of the local banks.

One of the possible solutions may be finding the strong reputable strategic partners. The state will be active in that direction too, both in the context of the ownership transformation which made the state a temporary majority shareholder in a number of local banks and in the context of issuing approvals regarding the acceptability of foreign bidders.

2.2.4 Restructuring process

The process of structural reforms (privatisation) of banks in Serbia started at the beginning of the year 2002, was based on the fourth stage of the NBY’s – Strategy of banking sector restructuring. It was generally expected that the process of the bank privatisation should have an indirect form (through privatisation of the companies, the shareholders of the banks), because banks in former Yugoslavia were transformed into joint stock companies in 1989.

However, the announced process of bank privatisation in Serbia, besides the mentioned indirect way, will have one phase more for a group of banks that have liabilities toward citizens and foreign creditors (Paris & London Club). According to the two enacted laws, the State of Serbia has converted those liabilities of the banks into the public debt. At the same time, on the basis of these public debts, the banks were obliged to issue new shares and the State swapped public debt for newly issued shares becoming the major shareholder in those banks. This new position of the State makes it possible, the above mentioned laws being mandatory, to find the strategic investors and sell to them the shares acquired through the swap (within the period of six months).

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So, the fourth stage of the NBY Program, defined as the bank privatisation process, is the current stage. The expectations of the restructuring process, are not only the ownership changes itself, but also, the new quality of bank’s corporate governance.

Even though the Serbian banking system is still in the making, two important goals have already been achieved:

- Only three banks are still under the management of Federal Agency for deposit insurance and bank rehabilitation, with the rest of 48 banks having already adjusted their volume and quality of operations to the international standards, prescribed by the Law on banks and other financial institutions.
- The fact that NBY issued six licenses to foreign investors for establishing the green-field banks, together with the above mentioned current position of the banks established mostly by the domestic capital, confirms that minimum of conditions for market competition has already been achieved.

Total number of employees in the banking sector of Serbia has also decreased from 26 thousand at the beginning of 2001, to 12.9 thousand in 2002.
### Consolidated profit and loss account of the Serbian banking sector

**Table 1**

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I Profit / loss from financial operation – from interest, fees &amp; other financial income / expenses (Banks under BRA in the total amount)</td>
<td>193,3</td>
<td>243,0</td>
<td>228,7</td>
<td>335,4</td>
</tr>
<tr>
<td>II Net operating income / expenses (Banks under BRA in the total amount)</td>
<td>-115,4</td>
<td>-165,2</td>
<td>-162,7</td>
<td>-251,9</td>
</tr>
<tr>
<td>III Net income / expenses from provisioning (Banks under BRA in the total amount)</td>
<td>-831,5</td>
<td>-3,245,7</td>
<td>61,0</td>
<td>-78,2</td>
</tr>
<tr>
<td>IV Net non-commercial and extra income / expenses (Banks under BRA in the total amount)</td>
<td>-151,0</td>
<td>-839,0</td>
<td>-166,4</td>
<td>-445,7</td>
</tr>
<tr>
<td>V Net re-evaluated income / expenses (Banks under BRA in the total amount)</td>
<td>120,7</td>
<td>-15,0</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>VI Profit / loss (Banks under BRA in the total amount)</td>
<td>-784,0</td>
<td>-4,022,0</td>
<td>-39,4</td>
<td>-440,4</td>
</tr>
<tr>
<td>VII Tax and contributions from income (Banks under BRA in the total amount)</td>
<td>1,8</td>
<td>2,6</td>
<td>0,1</td>
<td>2,4</td>
</tr>
<tr>
<td>VIII Net income / loss (Banks under BRA in the total amount)</td>
<td>-785,7</td>
<td>-4,024,6</td>
<td>-39,6</td>
<td>-442,8</td>
</tr>
</tbody>
</table>

Source: Profit and loss account of commercial banks in Serbia with the NBY license, as follows:
50 commercial banks at 31. December 2001. and
Some relevant data from the consolidated balance sheet of the Serbian banking sector

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>I Balance assets</td>
<td>12.002,8</td>
<td>11.336,6</td>
<td>4.667,7</td>
<td>4.951,9</td>
</tr>
<tr>
<td>(Banks under BRA in the total amount)</td>
<td>(-)</td>
<td>(6.776,7)</td>
<td>(27,7)</td>
<td>(207,7)</td>
</tr>
<tr>
<td>II Off balance items</td>
<td>6.558,7</td>
<td>7.225,2</td>
<td>3.031,9</td>
<td>3.459,4</td>
</tr>
<tr>
<td>(Banks under BRA in the total amount)</td>
<td>(-)</td>
<td>(5.852,5)</td>
<td>(129,8)</td>
<td>(272,4)</td>
</tr>
<tr>
<td>III Total capital</td>
<td>393,7</td>
<td>-3.474,2</td>
<td>1.221,9</td>
<td>992,2</td>
</tr>
<tr>
<td>(Banks under BRA in the total amount)</td>
<td>(-)</td>
<td>(-4.307,2)</td>
<td>(-24,2)</td>
<td>(-18,4)</td>
</tr>
<tr>
<td>IV Equity capital</td>
<td>942,4</td>
<td>647,9</td>
<td>1.135,2</td>
<td>1.251,6</td>
</tr>
<tr>
<td>(Banks under BRA in the total amount)</td>
<td>(-)</td>
<td>(2,1)</td>
<td>(110,5)</td>
<td>(116,9)</td>
</tr>
<tr>
<td>V Classified assets</td>
<td>9,2</td>
<td>6.634,0</td>
<td>3.254,5</td>
<td>4.084,5</td>
</tr>
<tr>
<td>(Banks under BRA in the total amount)</td>
<td>(-)</td>
<td>(3.983,8)</td>
<td>(155,9)</td>
<td>(243,8)</td>
</tr>
</tbody>
</table>

Notes: There were 9 banks under the management of BRA in 2001. In the meantime, four biggest banks under BRA were liquidated at the very beginning of 2001, and two small banks under BRA were merged with one big bank also under BRA. So, there are only 3 banks under the BRA management in the 2002.

Source: Balance sheets of commercial banks in Serbia with the NBY license, as follows:
50 commercial banks at 31. December 2001. and

2.3 The Environment for Factoring in Servia

2.3.1 Potential Market

Generally speaking, potential market for factoring in Serbia, requires three conditions of the essential importance to be met:

- Country’s return to international financial organizations;
- Macro-economic stability, specially monetary stability;
- Capacity of real sector of economy to produce quality and competitive goods, supported by the capacity of the domestic banking sector in the field of credit activity for providing necessary working capital.

The first condition has already been met:

- The return to international financial organizations after more than a decade of total isolation has been performed in an extremely short period of time;
- The 66% write-off of Paris Club debt shrunk the foreign debt by 3,0 billion USD;
- The foreign trade has been liberalized and donations from abroad have rendered 1,8 billion USD financial assistance;
- Financial support from the World Bank, IMF, EBRD and EIB sent positive signals to the private capital to more boldly enter into the projects offered by the Yugoslav enterprises;
- The first phase of candidacy to access the European Union will further contribute to the positive outlook for doing business here;

Stabilization policy during 2001 was mostly relying on the implementation and efficiency of the monetary policy instruments, so that the excellent results in the field of the monetary stability were achieved in 2002:

- The National Bank of Serbia indicates that in the first quarter of 2003 inflation figure of 1,8 % confirms attainability of the target level of 9,0% for the whole year 2003;
- Although dynamic, the monetary aggregate growth during 2002 was fully covered with foreign currency reserves (monetary stocks covered with the foreign currency reserves by 116,2% at the end 2002, also the prime money covered with 164,2%)
- Significant decrease of the average interest rate on banking loans from 4,58% per month in January 2001 down to 1,50% per month in December 2002, results mostly as positive follow up effect of the monetary movement stabilization and the banking sector reforms;
- Local currency, dinar, has been stable and the inflation has been successfully curbed, with the forecasts that 2003, as the third year in the row experiencing lowering of the inflation, will see the inflation falling to one digit figure, which has not been around for many decades in the past;
- Banks are experiencing a revival of public confidence. A proof for that are the increasing number of approved credits and the growth of household savings by more than forty times, from 20 to over 750 million EURs;
- The privatization has been gaining momentum and is expected to definitely change the economic environment.
Projection of macroeconomic indicators rates in FRY

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Domestic Product</td>
<td>5,5</td>
<td>4,0</td>
<td>5,0</td>
<td>5,0</td>
<td>5,0</td>
</tr>
<tr>
<td>Retail Prices</td>
<td>39,0</td>
<td>15,5</td>
<td>9,0</td>
<td>7,0</td>
<td>5,0</td>
</tr>
<tr>
<td>Consumption</td>
<td>11,1</td>
<td>11,7</td>
<td>3,0</td>
<td>2,6</td>
<td>2,7</td>
</tr>
<tr>
<td>Investments</td>
<td>21,1</td>
<td>18,0</td>
<td>22,5</td>
<td>25,4</td>
<td>22,9</td>
</tr>
<tr>
<td>Exports</td>
<td>9,4</td>
<td>12,9</td>
<td>20,4</td>
<td>14,5</td>
<td>13,3</td>
</tr>
</tbody>
</table>


The capacity of real sector in Serbia has to be viewed through the enterprises liquidity problem that still has an macro-economic dimension. Unlike the banking sector, restructuring of the companies in Serbia during 2001 and 2002, was lagging behind, and also the real sector of economy was constantly been facing the liquidity problems and business losses.

Partly undertaken financial rehabilitation of big firms at the beginning of September 2002, through one single swap operation of the enterprises’ cumulated debts into state issued securities, was completely inefficient (except for a short period of deblocking of the companies’ accounts), and that exercise also confirmed:
1. the existence of high moral hazard risk in the domestic enterprises as the number of illiquid companies and the level of uncollected debts has rose again at the beginning of the fourth quarter of 2002 (Table 4, columns 3 and 4), and
2. the need of deep structural reforms of the enterprises (of ownership, organization and business policy), as quickly as possible.

It is important to overcome the situation, not only because of the overall economic activity, but also because of the Balance of Payment deficit, especially with developed countries.

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<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Number of big illiquid</td>
<td>24.759</td>
<td>27.043</td>
<td>27.985</td>
</tr>
<tr>
<td>companies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Uncollected debts in millions of EUR</td>
<td>590,9</td>
<td>1.049,4</td>
<td>1.096,4</td>
</tr>
</tbody>
</table>

Source: Clearing House Announcements, NBY

The most important conclusion is that the chronic problem of insufficient level of working capital in Serbian companies, has been present in the last 12 years, and that there has been no adequate bank credit supply, on the other side.

The problem will be rising, because of the expected positive trend in the production volume growth, as well as because of the necessary faster working capital turnover.

The above described situation indicates the advantages for factoring market in Serbia. Concerning the country risk, brief insight into the overall export destinations (Table 5) indicates that the country risk involved should be considered relatively low:
# 2.3.2 In-house Factoring vs. Factoring Company

The dilemma in-house factoring vs. factoring company in Serbia has various pros and cons.

The Law on banks and other financial organizations explicitly sets factoring concept (purchase of receivables) as a banking product outside the core banking (Article 22). This underpins the view that it is not necessary to establish separate financial organizations to operate Factoring in Serbia, as banks can perform those operations in-house.

After radically undertaken reforms of the banking sector in the last two years, an assessment is that some banks in Serbia will be in a position to operate factoring, but selectively (for important clients), and in a limited volume.

Generally speaking, for the time being, most of the banks in Serbia have been occupied with the problem of restructuring, so that they would not be able to serve the overall demand of domestic market for factoring.

On the other side, the series of arguments are supporting the preference of the establishment of the factoring company, even though this option does not exclude bank operating a factoring in-house unit.

These arguments include:

- A factoring company is able to overcome the initial difficulties arising from the operational particularities of this new financial concept with the technological and financial assistance of a foreign factoring company as a partner.
- A factoring company decides on credit applications of their clients on criteria different from those used in the process of evaluating the credit worthiness by banks. Factoring companies attach great importance to the potential market of a prospect, the quality of its products, the possible future development, the soundness of the management and the credit worthiness of the buyers. Banks on the other hand tend to base their credit decisions on the findings of the balance sheet analysis, the track record of the client and the securities and collaterals offered. In order to avoid clashes caused by these diverging points of view, it is advisable to operate factoring business separately from that of the bank.
- The advances extended to the clients are directly linked to the increase of turnover and this is the big advantage of the new tool in comparison with the traditional bank financing. In order to achieve this, the factoring company is obliged to react very quickly to the requests of the clients regarding mainly the determination of credit limits for new customers and the increase of existing limits. This is possible only if factoring operations remain flexible and separate from the structure of the bank.
- Factoring companies by definition should be experts in the field of credit risk evaluation. They apply appropriate methods in assessing the creditworthiness of the customers and classify them into groups on the basis of their financial situation. Thus the percentages of overdue accounts decrease to a great extent and, correspondingly, the ability of the client to meet his current obligations improves.

### Table 5

<table>
<thead>
<tr>
<th>Region</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>43.13 %</td>
</tr>
<tr>
<td>Other developed countries</td>
<td>1.74 %</td>
</tr>
<tr>
<td>Transition countries</td>
<td>10.73 %</td>
</tr>
<tr>
<td>Central European Countries and others joining the EU</td>
<td>6.20 %</td>
</tr>
<tr>
<td>Former Republics of Yugoslavia</td>
<td>31.80 %</td>
</tr>
</tbody>
</table>
Two restricting factors still exist:
- The need for education;
- The problem of supervising factoring companies.

In 2001 National Bank of Yugoslavia was not ready to support the initiative for the legal framework to regulate specialized financial organizations, that would inter alia reduce the relatively high threshold of equity capital required. The National Bank of Yugoslavia did not want the creation of yet another type of financial organizations to be supervised by them, along with banks and various types of savings institutions. There are hints that NBY is seconding the idea that the supervising function should be organized as the Financial Services Authority.

On the other side, there is a need for education for target groups in various sectors, including the financial industry itself, to help them understand the concept of factoring, especially addressing following issues:
- organizational concept
- risk awareness
- know how of factorable goods, producers (sellers) and buyers (debtors)
- difference between factoring and forfaiting concepts
- time value of money concept.

The practice in Serbia has already made the situation more complex as commercial firms registered with the Commercial Court often include in their scope of activities factoring and/or forfaiting. Such firms usually are established with minimal capital requirement and with a modest total number of employees. Financial markets can be harmed because of such oversimplified perception of the two important forms of financing and refinancing of production and exports.

In the above mentioned initiative of the Association of Yugoslav banks in 2001 to amend the Law on banks and other financial organizations and the Law on Foreign Exchange Operations, it was proposed: (a) to introduce within the category “other financial organizations” a new entity “specialized financial organization”, to be organized as a joint stock company with the minimum capital requirement of USD 2.0 million; and (b) to make it possible for a specialized financial organization to obtain the authorisation for the foreign payment transactions (i.e. to operate its own accounts with foreign banks rather than to go through other local authorised banks). The arguments in more detail regarding the necessity of such explicit legal regulation can be found in Part Two of this Study.

### 2.3.3 Prospects for domestic and export Factoring considering the current economy characteristics

Possibilities for export factoring in Serbia, face two limits:
- The quality of export goods, and
- The volume of export.

An overview of the volume and the structure of export in FRY for 2002, indicates the following conclusions:
- After a long period of export volume decreasing in FRY, very little progress in the export production was recorded in the first half of 2002. This trend of growth was continuing in the following months of the year, however without meeting the expectations for 2002.
- Observed cumulatively, the volume of total export in FRY for 2002 (237,6 million EUR) was higher for 13,5% compared to the same period of the previous year (see table 1, column 2 and 3).
The volume of export to Developed Western Countries in 2002, (1.186.6 million EUR), is dominant in the structure of the export volume as a whole and has reached 50,06% of export.

The dominant export products in 2002 were intermediate goods (1.374,5 million EUR), which represented an increase of 53,8% with respect to 2001, and consumption goods (822,3 million EUR), which represented a 63,3% increase, also with respect to 2001.

Export volume in FRY & financial support (in millions of EUR)

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</thead>
<tbody>
<tr>
<td>Total</td>
<td>1.320,4</td>
<td>2.087,6</td>
<td>2.370,6</td>
</tr>
<tr>
<td>Developed Western Countries</td>
<td>717,5</td>
<td>1.099,2</td>
<td>1.186,6</td>
</tr>
<tr>
<td>Developing Countries</td>
<td>61,7</td>
<td>120,9</td>
<td>106,9</td>
</tr>
<tr>
<td>Countries in Transition</td>
<td>541,1</td>
<td>867,4</td>
<td>1.077,0</td>
</tr>
<tr>
<td>Total</td>
<td>100 %</td>
<td>100 %</td>
<td>100 %</td>
</tr>
<tr>
<td>Developed Western Countries</td>
<td>54,33 %</td>
<td>52,65 %</td>
<td>50,06 %</td>
</tr>
<tr>
<td>Developing Countries</td>
<td>4,67 %</td>
<td>5,80 %</td>
<td>4,51 %</td>
</tr>
<tr>
<td>Countries in Transition</td>
<td>41,00 %</td>
<td>41,55 %</td>
<td>45,43 %</td>
</tr>
</tbody>
</table>


Table 7.

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<tr>
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</thead>
<tbody>
<tr>
<td>Intermediate goods</td>
<td>782,9</td>
<td>1.182,1</td>
<td>1.374,5</td>
</tr>
<tr>
<td>Capital goods</td>
<td>109,1</td>
<td>178,3</td>
<td>173,8</td>
</tr>
<tr>
<td>Consumption goods</td>
<td>428,2</td>
<td>727,1</td>
<td>822,3</td>
</tr>
</tbody>
</table>


An realistic assessment, concerning the above conclusions, is, that the major potential markets for Serbian exports, for the time being, are the former republics of SFRY.

The imperative for the export to account for the sizeable portion in GDP of the country of the size of Serbia (50 – 60%) calls for all possible sources, mechanisms and financial instruments to be made available for achieving this goal. One of the additional or rather alternative source of financing would be the factoring.

The prospects for domestic factoring have already been mentioned relating to the chronic problems of the insufficient level of the working capital in Serbian companies.

Yet another indicator of domestic factoring prospect can be pointed out – the fact that low purchasing power of the citizens makes it necessary for both manufacturers and retail firms to offer deferred payment sale of consumer goods.
2.4 Special focus on SMEs – The Market for the factors

In accordance with the information from the Agency for Development of SMEs and Entrepreneurship published in September 2002, in Serbia 185,000 enterprises were registered, out of which 64,000 are operating. In the overall real sector of the Republic SMEs account for 98,3 % of the total number of the enterprises, they employ 43,2 % of the total, and have 19,4% of working capital and 19,5% of equity and reserves. While that is one fifth of the fixed funds, they account for 41% of total income. Large firms employing in total over the half of employed labour force account for 80% of total losses, whereas SMEs account for 43,5% of gains.

Among SMEs 86,1% are privately owned. They employ 35,5% of labour force, posses 27,5% of fixed funds, 27,2% of equity and reserves and are making 68,6% of total income.

SMEs socially owned employ 37% of labour force, posses 27,5 % of fixed funds, 27,2% of equity and reserves and are making merely 14,4 % of total income.

In Serbia the SMEs are in expansion. Serbia has adopted The Strategy for Development of the SMEs and entrepreneurship in the Republic of Serbia 2003-2008 in which the strategic objectives, priorities, instruments and institutions for the implementation are defined. This will form the basis for consistent state strategy in financial, institutional, regulatory and educational support for the SMEs sector.

The lack of financial funds and difficulties in accessing the funds is the major problem of the SMEs, especially for those in the early stage of their development.

Banks are traditionally inclined to finance large enterprises being their major investors. Difficulties in financing SMEs primarily are coming from higher risk as the appropriate collaterals and securities are not available. That results in less favourable conditions in bank lending to SMEs. This problem is addressed in Part Two of the Study.

Some improvements are visible, however, in banks' lending to the SMEs as some changes are taking place:

- Banks have experienced the growth of their credit potential on the basis of household savings increase,
- State has procured several credit lines from abroad earmarked for SMEs and disbursed through a number of banks,
- Donors funds were made available to the SMEs, disbursed through a number of banks.

Some of the foreign credit lines for SMEs now available are:

  In turn, the NBY signed agreements with 5 commercial banks: Eksimbanka, Beograd, Novosadska Banka, Novi Sad, Zepter Banka, Beograd, Cacanska Banka, Cacak, and Komercijalna Banka, Beograd, entrusting them to administer the credit line.
- European Investment Bank (EIB) signed an agreement with the FR Yugoslavia (borrower) and the National Bank of Yugoslavia (agent) on 16 July 2002 for EUR 20 million, with tenor of 12 years and grace up to 3 years and interest rate of 7,9% p.a.
  National Bank of Yugoslavia signed agreements with Eksimbanka Beograd and Komercijalna Banka, Beograd, entrusting them to administer the credit line.
KFW, Frankfurt, granted credit lines to Kulka Banka, Kula, Zepter Banka, Beograd, and Komercijalna Banka, Beograd, with tenor of 3 years and grace of 6 months, interest rate of 9.5 to 12 percent p.a.

Regarding the terms and conditions of the credits that the banks extend from their own potential, more convenient conditions could be expected as competition and curbing of the inflation in 2003 down to one digit percentage should make it possible for the banks to lower the interest rates.

Pledging of real estate (mortgage) has been an obstacle for extending credits. The major part of the real estate in Serbia has not been entered into the registers of real estate. Serbian government has launched a campaign for the real estate to be registered. The objective is twofold: to enhance the privatisation process and to alleviate the problems regarding the mortgage credits.

Besides that, the pledge of other property including machines, raw materials, inventories, etc. has only recently been adequately regulated to serve the purpose in properly securing the lenders.

Support to SMEs, concerning the volume of outstanding loans for export production is as follows:

<table>
<thead>
<tr>
<th>Table 8.</th>
<th>(in mln. EUR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>7,4 (September '02)</td>
</tr>
<tr>
<td>To the SMEs</td>
<td>35,1</td>
</tr>
<tr>
<td>To the Shops</td>
<td>4,7</td>
</tr>
</tbody>
</table>

Notes:  
1. The volume of total loans extended by banks in those months.  
2. The volume of outstanding loans per 30th September 2002.  
3. The volume of outstanding loans per 30th September 2002.  
Source: Row No 1 - NBY. Rows 2&3 - Special Survey by the Association of Yugoslav Banks and Other Financial Organizations.

Table 8 gives ground for the following conclusions:

- The total volume of the loans to the enterprises in Serbia had a rising trend during 2002, by months.

- The special questionnaire about the volume of outstanding loans to the SMEs and the shops for export production has been filled out by 17 banks (40.3% of Serbian banking sector total assets as per 30. September 2002.)

- The total amount of outstanding loans to the SMEs for export production in Serbia is higher, taking into account the total number of banks (50), but, nevertheless, data is representative presenting the volume of outstanding loans to the SMEs for export production, extended by the banks specialized for financing SMEs, some of them chosen to on-lend the credits to SMEs and shops from the international credit lines (European Agency for Reconstruction, KFW Frankfurt, etc.).

The above analysis also points out the following indicators of substantial prospects for both export and domestic factoring in Serbia:

- The positive expectations about the future trend of Serbian export production growth.

- The rising need of Serbian companies for faster turnover of current assets, reflecting the chronic problem of insufficient level of working capital in the last twelve years. The problem will be growing hand in hand with the expected trend of export production growth. Export factoring should be the adequate solution - domestic enterprises should be in the position to solve the problem of low liquidity and improve their production cycles.
Equally, the revival of financial support to the SMEs, especially for export production, through banking loans, refinanced by international credit lines, indicates broadening of possibilities for factoring in Serbia.

Generally low purchasing power of the citizens makes it necessary for manufacturers and commercial retail firms to have in place deferred payment arrangements for the consumers. Thus, domestic factoring will provide alternative financing for retail deferred payment sale of consumer goods.

2.4.1 **Key issues in Banking/Financial system of Serbia to be dealt with**

Some key issues in banking/financial system have particular bearing on the factoring prospects representing obstacles.

Domestic financial sector is still underdeveloped and it lacks variety of market participants and variety of financial instruments. The introduction of new market participants and new financial instruments takes expertize, time consuming initiatives and procedures, therefore an effort has to be made by interested parties to find more efficient paths that would lead to efficient development. Development of financial sector is extremely needed and the State should attach great importance to that task as otherwise the vital goals of economic policies cannot properly be pursued. Especially, with the imperative of enhancing the exports and the economy growth, the State has to fill in the gap in regulating the financial markets in order to make them in all respects harmonized with the EU and OECD standards. Other interested parties include the banks and the real sector of economy.

To that end various financial markets should be established, with particular importance attached to the interbank markets making the vital part of such markets (money market, repo market, forex forward market, bank acceptance market).

Also, in order to have the efficient markets certain standards have to be observed, including the standard relating to the market participants. The market participants have to be regulated and supervised, so that the proper prudential and other requirements securing the health of the markets can be in place, i.e. minimal capital requirements they will have to maintain and the business standards they must observe. In such a set up, each participant has to adhere to the practice ensuring that the inherent risks are indentified, controlled and covered. Specially, banks need in their environment developed modern financial markets with a variety of market participants.

Accounting and tax issues regarding the financial instruments should be addressed on the ongoing basis as the effects of accounting and taxes may be serious obstacles to adopting instruments that have wide use in foreign financial markets. The aversion towards the discount based finance and financial instruments should be addressed on all levels in the banking industry and in the environment. Also the State should encourage the introduction and use of the discount based concepts of financing, by adequate tax and accounting treatment.

2.5 **Conclusions and Recommendation**

After a decade of decline and stagnation, Serbian economy has moved to the renewal. Three basic, short terms, economic goals were defined in 2001: monetary stability, bank rehabilitation and fiscal reform.

Achieved macroeconomic stability, specially monetary stability, in 2001 and 2002, along with the country’s return to the international financial organizations, made the macroeconomic conditions favourable for the potential factoring market in Serbia.

Concerning the country risk, brief insight in the overall export broken down by destinations indicates that country risk involved should be considered relatively low.
The capacity of real sector economy in Serbia has to be viewed through the enterprises liquidity problem, that still have an macroeconomic dimension, because the reforms of Serbian companies in 2001 and 2002, lagged behind the bank rehabilitation.
This situation has to be resolved not only because of the economic activity but also because of the Balance of Payment deficit.

In turn, the above described situation indicates that the prospect for factoring market in Serbia is substantial both because of the expected raising of product volume and necessary faster working capital turnover, and also because of the insufficient bank credit supply. Besides the series of arguments that are supporting the preference of the establishing of the factoring company in Serbia, this option does not exclude bank operating a factoring in-house unit.
On the contrary, these two options are complementary:
- because reformed banking sector in Serbia will be capable to operate factoring,
- because of the existing legal framework (the Law on Banks explicitly sets factoring concept as a banking product).

On the other side, banks in Serbia will not be able to meet the whole domestic market demand for factoring, if only because being occupied with the restructuring process.
Foreign factoring companies are necessary on the Serbian market, because of advantages, such as: know how, experience, faster procedure of credit risk evaluance, faster decision making process.

**Recommendation:**
The parallel presence of factoring companies and the banks’ factoring in-house units, on the Serbian market, is necessary and possible, because of the volume of demand for factoring services, and also because of the possibility of complementary operating.
Revival of financial support to the SMEs, especially for export production through banking loans, refinanced by international credit lines, also heralds the new possibilities for factoring in Serbia.
Factoring gives the possibilities for enterprises to timely access alternative financial source, that may grow with the enterprises needs. That is of great importance for SMEs in Serbia, as SMEs will continue to face the chronic shortage of working capital.
The bottom line is that there are all reasons to assume that in Serbia factoring will have solid grounds for development, because of strong need of companies in Serbia, specially SMEs, for such type of alternative financial support. Factoring in Serbia should also have strong support by monetary and tax authorities, whose interest is to boost the exports, to combat the grey economy, to ensure the money flow and to ensure an overall development of financial markets as precondition for the economic growth.
3 LEGAL ISSUES

3.1 Introduction

Factoring as a commercial service is based on factoring contracts. The UNIDROIT Convention on International Factoring (Ottawa, 28 May 1988) regulates the particularities of the relationship. It defines a factoring contract as a contract concluded between one party (the supplier) and another party (the factor) pursuant to which:

- The supplier may or will assign to the factor receivables arising from contracts of sale of goods or services made between the supplier and its customers (debtors) other than those for the sale of goods bought primarily for their personal, family or household use;

- The factor is to perform at least two of the following functions for the supplier:
  - Finance for the supplier by advance payments;
  - Maintenance of accounts (ledging) relating to the receivables;
  - Collection of receivables;
  - Protection against default in payment by debtors;

- Notice of the assignment of the receivables is to be given to debtor.

The Convention on International Factoring should be ratified by Serbia and Montenegro, as its prime business partners have ratified it as well.

The only piece of legislation which mentions the term «factoring» is the Law on Prevention of Money Laundering ("OJ FRY", No 53/2001). In this law it is provided that legal persons and entrepreneurs who are engaged in leasing, factoring, forfaiting, and other “sensitive activities” are subject to the obligations prescribed by this law. This is all about factoring in our legal system.

3.2 General Contract Law Framework

Yugoslav Civil law is based on legislature (not case law), and belongs to the Germanic family of the Continental legal system. Historically, strong influences can be traced from the General Civil Code of Austria, the German pandekten division of civil law, and the Swiss Code of Obligations. These influences were not direct; rather they came via three domestic landmark codifications. French, German, and Austrian jurisprudence made an impact on Yugoslav civil law through the academic careers and practicing of Serbian lawyers educated in those countries. In the field of business law, influences of international legal instruments (conventions, model laws, UCP-s and terms) and Common law (English and US laws) are gaining momentum.

Law of obligations is dominated by the federal Law on Obligational Relations² (LOR). In effect, save for some amendments, it was drafted by professor Mihailo Konstantinovic whose inspiration came primarily from the Swiss Code of Obligations whose drafting style Konstantinovic praised to be the right compromise between the minutely written BGB and the elegant eloquence of the Napoleonic Code. It is noteworthy that the Law on Obligational Relations is one of the few relics which survived the brutal breakup of Socialist Yugoslavia and remained effective in all new states created on its territories.

² "OJ SFRY", br. 29/78, 39/85, 45/89 *), 57/89, "OJ SRY", br. 31/93.
LOR provides comprehensive regulation of general contract law, and commercial variations thereto (thus accepting the principle of unity of civil and commercial contract law). Special provisions for nominate contracts (both classical and some commercial) are included. Factoring is not regulated however. Some other nominate commercial contracts are provided for in special laws dealing with foreign trade, industrial property, etc. Usages, general and special, are applied in construction of contracts, if the parties expressly incorporated them or impliedly expected their application at the time of conclusion of contract. As the law of Obligations regulates commercial as well as classical contracts, Yugoslavia does not have a separate commercial code.

The Law on Obligational Relations also regulates other sources of obligations, namely: the law of torts (compensation of damages), unjust enrichment (condictio sine causa), negotiorum gestio (acting in affairs of another person without its mandate but for its benefit, creating thus an obligation between the beneficiary - debtor, and the negotiorum gestor - creditor), unilateral legal acts - Rechtsgeschäft (effects of a binding offer, of issuing a negotiable instruments, of public promise of award - unilaterally creating an obligation). Modifications (conditions, calculation of terms, modus) as well as limitation periods, and consequences of incapacity are regulated in this basic instrument.

The law contains general principles of civil law, some of which have immediate application (e.g. freedom of contract, good faith and fair dealing, prohibition of abuse of rights, application of good business practices), while others need to be specified by substantive law institutes (e.g. application of supplementary dispositive rules, principle of proportionality of mutual obligations, compensation of damage caused to others). The general principle of proportionality of mutual obligations is concretised by positive law principles also contained in the LOR such as: responsibility of vendor for material and legal (eviction) deficiencies; laesio enormis (right to ex parte action for court annulment of agreement for reasons of evident value disproportion of mutual obligations in favour of the innocent party), rebus sic stantibus (right to ex parte action for court alteration or rescission of agreement on basis of unforeseen and unavoidable circumstances which have occurred after the conclusion of the agreement and which seriously burden the performance of duties of a party to the agreement); usurious agreement (ex officio null agreement because in it one party abuses the hardships of the other to contract for itself or a third party benefits which are in obvious disproportion with duties it took upon itself).

It is justifiable to conclude that the Law on Obligational Relations serves some of the purposes of the General part (Allgemeine Teil) of civil law.

Do we have an adequate contract law framework for factoring?

3.3 Factoring contract Law Framework de lege lata

Factoring contract is not regulated as a nominated contract in our legal system in any piece of legislation. The Law on Obligational relations provides a solid contractual framework for assignment of receivables under the title: Assignment of claims by contract in articles 436-445. Most of these provisions can be derogated from and apply only if not regulated by contract otherwise.

Between the assignor and assignee, by virtue of the contract of assignment itself the receivable/claim is transferred from the assignor to the assignee, although the debtor has not been informed. The assignment however effects the debtor only after notification, as he can prior to notification validly discharge his obligation by paying to the assignor.
LOR does not specify any particular form for notification, thus theoretically it can be oral as well. A written notification of assignment is common and best suited for factoring. There appears to be no obstacle from a contract law perspective to agree on a master factoring agreement as in regular use in countries familiar with the concept of factoring. The transfer of the receivable in that case shall occur at the moment of its creation between the debtor and assignor.

The assignment of receivables may be restricted by express agreement between creditor and debtor, either with the effect to prohibit any assignment at all, or to make the assignment subject to the debtor’s approval. Such prohibitions are not commonly in use. Assignment in contradiction with such term of basic agreement would not have effect towards debtor (LOR, article 436.2).

Retention of title (pactum reservati dominii) is known in Serbian law only in respect to ownership on corporeal things. Retention of title means, that the buyer gets full ownership of the bought goods after full payment of the invoiced amount. If the buyer has not paid in full, the seller remains owner of the goods. This enables the seller - in case of bankruptcy of the buyer - to exclude the goods from the bankruptcy estate. If "retention of title" is agreed between seller and buyer and it is as "Accessory Right" passed with the claim to the recipient by assignment, which is the Factoring company, then the Factoring company can either take back the goods (if they have prepaid the respective invoice) or they are entitled to the proceeds, in case the administrator (liquidator) has the goods already sold. Provisions in Articles 436-445 of LOR do regulate general assignment of receivables well.

LOR provisions on the assignment of receivables however do not regulate certain particularities of the factoring relationship needed by factoring business. The factoring contract, in principle, can regulate particularities of the factoring relationship. On the other hand the business community, courts, tax authorities and other administrative bodies are not familiar with the factoring relationship and need guidance. Having a law on factoring would be more authoritative than factoring contracts before courts and administrative bodies, and it would unify the approach to factoring from the outset. This law should inter alia regulate the relationship aspects based on the approach taken by the Convention on International Factoring.

Beginners mistakes would thereby be avoided in the interpretation of contracts and the transaction in general by courts, Foreign Currency Inspection, National Bank and tax authorities. For this same reason leasing is regulated in a special Law on Leasing. This does not mean that factoring cannot be operated without such a law. Yet, it would be easier if Serbia had a law on factoring which flexibly regulated the factoring contract relationship.

### 3.3.1 Potential legal barriers to Factoring

Slow Court Procedures for Collection of Claims and Proposal for the Introduction of «Documentary Procedure».

It is essential for factoring business, in case of debtor default, to have an efficient system of court ordered collection of receivables. Courts in Serbia act on basis of the Law on Execution Procedure (2000) which does not provide for an efficient collection procedure and needs to be revised to make it more impactful for the creditor.

Historically the enforcement of final judgements has been problematic in Milosevic’s nineties for several reasons.
Firstly, the Laws on Executive Procedure (previous and the present Law of 2000) favour the debtor by a prolonged and cumbersome execution procedure.

Secondly, in the nineties the courts simply refused to enforce final judgements against certain debtors either because of their political affiliations or for reasons of «social peace». In other words, courts had selectively applied the law. You could have a final and executive court decision rendered in the execution procedure, but the courts simply would not operate to effect the order contained therein. In some cases the court requested the help of police in execution and the police refused to assist, claiming that the execution could be so dangerous that it is not worth doing it. As the court clerks could not operate without the police due to possible dangers surrounding the execution, execution simply would not happen. In this way the police frustrated, when it wished so, the judicial system, and this of course was based on orders from the political oligarchy.

In addition to this, a problem with inaccurate land registries, lack of registries for movables, scarce funds in the collapsed banking system, no exchange of information between banks, overall criminalisation of the society and general feeling of insecurity brought people to the thinking that courts are of little help. Gangsters were thus not seldom used to force debtors to pay, and a commission of 15-20% was charged for the service.

General ambience for collection has improved as organized crime is seriously challenged by the police action taken after the assassination of Prime Minister Djindjic. The courts however have not improved sufficiently for various reasons. An efficient system for court collection of receivables still does not operate in Serbia and among the principle obstacles are inefficient provisions contained in Law on Execution Procedure. Normally, the creditor has to obtain a final judgment in civil trial procedure, and then based on it, to pursue the execution procedure until collection is effected. The description of the law as it is and suggestions for improvement follow.

LOR regulates substantive law rights of creditor in case of default of debtor.iii

Before commencing trial procedure a registered mail warning letter should be sent to the debtor, asking performance within e.g. 7 days, the failure of which will result in filing suit against the debtor. This warning letter makes it impossible for the debtor to claim that it wanted to pay, but had no notice thereof, so that the court costs would be transferred to the plaintiff / creditor who filed suit without being truly compelled to do so.

The regular collection procedure begins with civil procedure trial leading to a judgment ordering the defendant to pay the owed sum increased by statutory or contractual interest (whichever interest rate is higher), the court and the attorneys’ fees. Once this judgment becomes final and binding (15 days after rendering unless an appeal is filed), an execution petition is filed based on the Law on Execution Procedure.

The Law on Execution Procedure’ was enacted in 2000, and it regulates:

- The procedure before court for the execution of due claims based on final judgments obtained in civil and commercial disputes.
- The law also applies for execution of final decisions and settlements brought by state administrative bodies and in petty crime procedures ordering monetary payments to be made.
- The procedure for introduction of interim measures (injunctions) and means for securing claims.

The execution procedure is initiated by filing to the court of petition for execution appended with an “executory document”. According to the Law on Execution Procedure an “executory document” is a final decision brought by court (judgment), any kind of arbitration, or administrative body, and a court settlements between the disputed parties.

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3 "OJ SRY", br. 28/00, 73/00, 71/01
An inefficient summary execution procedure is regulated in the Law on Execution procedure. Namely, civil procedure in theory can be skipped, and execution procedure completed if the creditor is a legal person or a trader and possesses a «veritable document». Instead of requiring an "executory document" (final judgment), in this case it suffices to submit to the court a "veritable document" which according to the law can be an «invoice, bill of exchange and cheque with a protest, a public document (deed), an excerpt from certified business books, a document executed in a legally prescribed form». In practice it is not clear what exactly is a «document executed in a legally prescribed form», as simple written form is required for many contracts, and most are binding based on oral agreement (principle of consensuality prevails). In our opinion, a «written document executed in a legally prescribed form» is every document for which additional requirements of form are not set by the law. This opinion is shared by judges of the Supreme Court of Serbia. This, in other words means that e.g. a sales agreement, documentary credit or bank guaranty agreement would be treated a “document executed in a legally prescribed form”, and could be submitted to court for initiating an execution procedure.

Nevertheless, the great drawback of this system is that if the defaulting debtor raises an exception against the plaintiffs “veritable document”, challenging its debt on any grounds - even without producing any evidence for its assertions - the court will automatically refer the matter to be resolved in an civil trial procedure, which brings us to the regular slow collection process.

Under the present Law on Execution Procedure shortcut is to execute commercial agreements in the form of court settlements under the Article 234 of the Law o Execution Procedure, as this court settlement is an “executive document” and can be submitted to the execution procedure directly, skipping thus the trial procedure. This is not a very efficient shortcut, as this settlement agreement is effectively a court document, so the parties have to petition to the court, the judge has to summon the parties, hold a hearing and get this document drafted in form of court settlement. However, this is still better than going through the cumbersome trial procedure.

It is obvious that the Law on Execution Procedure needs amendment to make it more effective for the creditor by introducing the so-called «documentary procedure». The Law needs to be changed so as to recognize only an exception raised debtor against a «veritable document» if the debtor submits to the court documentary evidence that the debt has been duly discharged (written proof of payment). In other words, if the debtor does not provide documentary evidence of payment within the term as set by the law (or court), the execution shall be carried out, and the debtor can initiate a trial procedure aimed at counter-execution. Simply, it is unacceptable that any unsubstantiated representation negating the debt made by the debtor can block the summary procedure and lead to automatic referral of the case from execution procedure to a cumbersome trial procedure.

In this sense the German Law on Civil Court Procedure in Articles 794a-800a regulates the so called «documentary procedure», and can serve as useful inspiration for introduction of adequate provisions into the legal system of Serbia. In order for the documentary procedure to be applied the agreement has to meet the following requirements:

- A precise and unconditional obligation has to be stipulated in the agreement;
- A clause has to be inserted stating that the parties agree to resolve the matter by directly going to the execution procedure;
- The agreement has to be executed in notarial form, where the notary public warns the parties of the seriousness of their decision to take this route.

When the debtor defaults under an agreement meeting these requirements, the creditor submits to the court such agreement as the «veritable document» and only provision of documentary evidence proving performance of debtor can stop the execution to be completed.
(The author of this text has expressed these views before various public fora, and they have been accepted as formal conclusions on the meeting of commercial law judges held in Niska Banja on 27-28 February 2002. The same conclusions prevailed on the meeting chaired by the author in the Economic Institute of Serbia which was devoted to collateral law.)

For effecting monetary payments the following action can be ordered by court: sale of movables, sale of real property, transfer of funds from debtor's current bank account to creditor's account, assignment of obligation to deliver goods, sale of other rights. The same can be done for securing payment, but instead of sale, a pledge or mortgage would be established by court order and appropriate action based on it.

Collection from bank accounts is effected with the aid of the Central bank which has the list of all bank accounts of the debtor company (or trader) kept in any of the banks, so that it orders the blockade of some or all of the accounts.

### 3.3.2 Empowering the Courts
Generally the courts are weak and need to be empowered:
- By better salaries of judiciary;
- By modern education and approach to the operation of law;
- By a more creative approach to case law;
- By better knowledge of foreign languages;
- By better access to foreign legal literature;
- By better access to internet;
- By adjusting the number of judges to the work burden in order to enable permanent legal education and other necessary activities;
- Courts must work more efficiently;
- Control mechanisms within the judiciary would have to be more efficient.

### 3.3.3 Foreign Exchange Operations Law
Foreign Exchange Operations Law and related legislation should not be problematic for operating factoring in Serbia. Important foreign exchange interests of the state are not imperilled. However, as factoring is a new concept to the entities involved (National Bank, Foreign exchange inspectorate, tax authorities) an understanding has to be reached with these bodies and adequate accounting and reporting techniques developed in detail, so as to make the operation function smoothly. For this work specialist legal advice is critical.

When analysing the situation if a resident factor buys cross-border foreign currency claims from a resident client who exported its merchandise abroad (export factoring) the following laws have to be taken into account:
- Foreign exchange Operations Law;
- Law on Foreign Credit Relations;
- Law on Banks and Other Financial Organizations.

In answer to the question whether assignment is permitted under the Foreign exchange Operations Law the National Bank of Serbia rendered the following opinion: “The Foreign exchange Operations law does not regulate assignment, but it does not prohibit the change of subjects of obligation, irrespective whether the change refers to the creditor or debtor. However, Articles 7 and 9 of the Foreign exchange Operations Law expressly stipulate the duty of importing of foreign currency into the country, which the resident company has realized abroad. Assigning of foreign currency claim from abroad to a third resident party does not release the assignor from its duty to import the foreign currency in the agreed term.”

The National Bank has finally adopted the liberal approach that if something is not prohibited
it is permitted. It happened that companies, which assigned their export receivables, had problems before the controlling bodies (National Bank and Foreign exchange Inspectorate) to explain the difference between the originally agreed price and the price received from assignment. Adequate agreements with these controlling bodies would eliminate such problems for factoring in Serbia. This was expressly stated by a high official of the National Bank of Serbia at the factoring presentation SEED of 18th of July 2003. The crucial issue is that factoring does not adversely affect the payment balance of Serbia as the foreign currency payments enter the country anyway through payments made to the resident factor.

Under the Foreign exchange Operations Law an export sale is considered a loan if deferred payment under the contract is agreed more than 90 days after export customs procedure is effected or service delivered abroad. So, in order to avoid the registration of foreign loan with the National Bank of Serbia, the agreed term has to be maximum 90 days. If deferred payment is agreed more than 90 days after these specified moments, the exporter has to notify the loan agreement to the National Bank of Serbia. The Law on Foreign Credit Relations, in Article 13, provides expressly that the creditor may pledge, assign, and collect before maturity foreign loans in compliance with the contract and the Law of Foreign Payment Operations. Thus, assignment of receivables is expressly permitted for resident persons.

There exist opinions that question the possibility of two domestic companies trading directly in cross-border foreign currency receivables (devizna potraživanja), as under the Foreign Exchange Operations Law the trade in foreign currency (devize) can be effected only between authorised banks (which deal in their name and for their account, or in another person’s name and for his account). These opinions are based on the definition of term “devize” as foreign currency claims. However, cross-border foreign currency receivables as only potentially collectable from abroad cannot be treated in the same way a “devize” which actually denote foreign legal tender already present in Serbia. Factor would collect his receivable from abroad through an authorised bank directly from the debtor (if notified of assignment), or via the foreign currency domestic bank account of the client (if debtor is not notified or this is agreed in the factoring contract).

The resident company has to collect its cross-border receivables in the agreed term under the contract or at latest 8 working days thereafter.

The client and the factor, as two resident companies, have to make mutual payments in dinars under the Foreign Currency Operations Law. Foreign Currency Operations Law, Article 4, prescribes that resident and/or non-resident companies perform payments in Yugoslavia, as a general rule, in Dinars. Payments in foreign exchange are allowed only in case of:
- payments under real estate purchase and lease,
- servicing foreign exchange loans that were extended in Yugoslavia by a resident bank to a resident entity,
- purchase of securities issued by resident entities that are denominated in foreign exchange,
- and several other cases which are not of relevance hereto.

Foreign Currency Operations Law in Article 21 allows for the possibility to conclude contracts in Yugoslavia in foreign currency, however payments under such contract would be in Dinars. Article 22 allows banks with authorisation to conduct foreign operations (“Authorised Bank”) to keep foreign currency in the country with another authorised bank. Authorised banks may keep foreign currency also with foreign banks.

Article 23 allows resident companies to keep foreign currency at foreign currency accounts with authorised banks. As a general rule, a resident company cannot maintain bank accounts with foreign banks.

Article 24 allows non-resident person to keep foreign currency with the foreign currency account with the authorised bank. Dinars accrued by non-residents in accordance with Foreign
Currency Operations Law may be kept in Yugoslavia on Dinar account with any bank, or be converted into foreign currency. Prepayments under a factoring agreement are not prohibited, and are a matter of contractual arrangement.

3.4 The legal status of potential factors

3.4.1 Banks

The Law on Banks and Other Financial Institutions regulates the incorporation, internal organization, operation, management of banks and other financial institutions.

Other financial institutions include (i) savings houses, (ii) savings/credit organizations, and (iii) savings/credit cooperatives. Savings houses can be established only by domestic legal and physical persons. Savings/credit organization collects deposits only from its founders, and grants loans only to its founders. Saving credit cooperative can be established only by cooperatives themselves or by legal and physical person who are members of the cooperatives. For the above stated reasons none of the three “other financial institutions” as regulated by the Law on Banks and Other Financial Institutions is adequate for operating factoring business. Banks are the only kind of institution under National Bank control adequate for operating factoring business.

The Law on Banks and Other Financial Institutions, in article 21, lists exclusive banking lines of business which cannot be operated by others, including deposit taking and granting loans. It is very thus very important to understand the legal nature of factoring which is different from granting loans. If factoring prepayments were understood as granting loans, then factoring business would be limited to banking institutions under Article 21. This approach would contradict international practices, and would not foster this business in Serbia. Factoring does not constitute a loan as no repayment exists, it is trilateral as opposed from bilateral loans, the work process and know-how deployed is very different from that required from banks giving loans. Factoring is prevailingly a ledgering and collecting operation fundamentally different from lending money.

The Law on Banks, in article 22, provides that “banks may also conduct the following business…(2) buying and collecting of receivables”, …(3) all other financial services. … These “additional” activities to the core banking business may be conducted under conditions set out in special federal laws». However, the law regulating factoring has not been adopted yet.

Banks are supervised by the National Bank of Serbia. A bank in Serbia may be established providing the following major requirements are met:

- Two financially sound founders whose credibility is established by the Central Bank;
- Joint stock company organization;
- Financial share capital not below Euro 10,000,000.00 at any moment;
- Central Bank approval of legality of submitted documents and justifiability of founding of a bank;
- Technical and professional capacity.

From the above said it appears clearly that banks can conduct factoring business, but have to comply with rigorous requirements set for every other bank by the National Bank in respect of incorporation and control of its operations. Nevertheless, their factoring operation not being their core business should not be of large volume, and should be done only for select clients. Chinese walls should be installed to minimize conflict of interests.
It is commendable for a bank to establish its subsidiary factoring company, which would benefit from the access to capital, but be a different entity, not being exposed to conflict of interest limitations. It appears that due to the specificities of factoring business, the factoring entity should have factoring as its core business, not an ancillary to banking operations.

3.4.2 Joint-stock Companies

The present Law on Companies⁴ (1996) regulates all forms of commercial companies in one piece of legislation like in France, Italy, Switzerland, Hungary, Japan and Slovenia, as opposed from Germany, USA, Austria which regulate partnerships separately from corporations. The omission of the law is that it did not regulate branch offices of foreign persons. Entrepreneurs are mentioned in principle and regulated by a separate republic law in detail.

The Law on Companies introduces four well-known company structures:

- private limited liability company;
- joint-stock company (stock society);
- partnership; and
- limited partnership.

The foreign investors to date have founded or acquired ownership or equity of limited liability companies in more than 80% of such acquisitions. Joint stock companies are seldom established (but have to be established in case of banks and insurance companies), and are used for larger investments only. The tax treatment of both types of companies is the same - corporation income tax is 14% in Serbian Corporation Income Law. Limited partnerships and partnerships are not registered very often.

Due to the capacity of joint-stock companies to attract larger capital we believe that this form should be used for factoring companies, and this should be regulated in the Law on Factoring to be adopted. Namely, the Factoring Law should provide that factoring joint-stocks companies should have a minimum pecuniary invested capital of US $200,000 for domestic factoring, while for operating abroad the minimum pecuniary invested capital should be US $2,000,000 (International Factor Chain standard). This to ensure the solidity of factors and thereby the reputation of the factoring industry in general.

Under the Law on Companies, the requirements concerning minimum investment in finance for incorporation of a joint-stock company (stock society) are as follows. If the shares are bought simultaneously (all at once by the incorporators) the minimum financial part of the capital has to be the equivalent of US $10,000 in Dinars. If the shares are bought successively (offered publicly) the same minimum is US $ 20,000 in Dinars. The minimum invested capital of a single individual shareholder has to be US $ 500.

The foreign investors’ pecuniary part can be denominated in foreign currency, which has to be equivalent of the said minimum sums. The foreign investor’s finance, which is invested into a local company, must be wired from abroad to an interim account established for the purpose of this transfer. As soon as the money hits this interim account, it has to be converted into Dinars, and a document is issued then to the founder, which is delivered to the court as one of the necessary documents for registration of the company.

Industrial groupings often have their financial arms in the forms of subsidiary factoring companies.

In any case, factoring should be the core business of a factoring company.

⁴ “OJ SRY", br. 29/96, 33/96, 29/97, 59/98, 74/99, 9/01.
Foreign branch offices are a good option for factoring but they do not exist under our law. Neither the Law on Companies nor the Law on Foreign Investment regulate foreign branches. Only representative offices can be opened, but they cannot do business. This situation has to change, as all European countries and the US are familiar with the concept of a foreign branch operation as cross border extension of foreign legal entity.

### 3.5 Recommendations

The above legal considerations suggest that the relevant legal provisions should regulate the following:

- The definition and the legal nature of factoring, the main services offered and the differences between this new financial instrument and a traditional bank business.
- The conditions for the factoring company to offer such facility (capital base, obligations towards the supervising authority, etc).
- The minimum legal requirements for the establishment of a factoring company in Serbia, such as the minimum capital base, the minimum qualification (experience, level of education, etc) of the persons in charge of a factoring company in order to obtain the appropriate license from the supervising authority, preferably the NBY.
- The procedure to be followed by those who are interested in establishing a factoring company, the documents to be submitted in the process of obtaining the license, e.g. a business plan including results of a market survey, a cash-flow budget covering the first three years of activity accompanied by an analysis of the break-even point, a chart of functions, the curriculum vitae of the members of the Board of Directors, description of the equipment and the specification of the software program that will be available, etc.
- The level of the main financial indicators that a factoring firm has to maintain (e.g. equity to debt ratio, current assets to short term ratio). Attention should be paid to the risk of concentration (the balance of the funds advanced to one client, its subsidiaries included).
- The extent and the preconditions for external audits of the books and the operations of a factoring company.
- The adoption by Serbia of the main provisions of the Convention for International Factoring.
- The priority of the rights in case that the same debt has been assigned twice.
- The formal requirements for a valid assignment of receivables arising from domestic credit sales.
- The rights and duties of the supervising authority.
- The necessity of a fair tax treatment of the factoring operations in order to encourage the interested investors as well as the prospective clients to participate in the market.

More generally the State through the financial authorities should do the following:

- Sign and ratify the UNIDROIT Convention on International Factoring.
- Use joint-stock companies as the prime vehicle for introduction of factoring in Serbia.
- Draft and adopt a Law on Factoring which shall regulate:
  - Factoring contract relationship in line with the UNIDROIT Convention;
  - Special requirements for banks and companies doing factoring in the country and abroad (minimum capital, et alia);
  - Position of factor in bankruptcy procedure;
  - Insurance requirements;
  - Summary «documentary procedure» for fast collection of debts if the Law on Execution procedure is not amended.
- Draft and adopt amendments to the Law on Execution Procedure by introducing the summary «documentary procedure» for fast collection of debts.
- Introduce foreign branch offices in the new Law on Commercial Companies.
4 ACCOUNTING AND TAX ISSUES

4.1 Accounting Issues

4.1.1 Accounting Framework in Yugoslavia

Accounting requirements in Yugoslavia are prescribed by the Federal Law on Accounting, enacted in 1996 and amended several times, latest amendments made in December 2001.

Underlying accounting principles for the preparation of financial statements are similar to the Generally Accepted Accounting Principles with regard to going concern, consistency, prudence, matching revenues and expenses, accrual accounting. However, there are still departures from International Accounting Standards on specific accounting treatments like inflation accounting, leasing, deferred taxation.

The accounting standards referred to in the Law on Accounting are not specified. However, the Law on Accounting authorizes the Yugoslav Association of Accountants and Auditors (YAAA) to set the accounting and auditing standards. The YAAA is a member of IFAC and have translated and published a certain number of International Accounting Standards but the National Accounting Standards (NAS) are still applicable.

Statutory financial statements do not include relevant notes that may help readers understand better the business of a company. Financial reports consist of the balance sheet, income statement and annex (supplementary statement for all companies). Cash flow statement and operating reports are only required for medium and large enterprises as well as banks and financial service companies.

The companies are obliged to use a chart of accounts which is a standard grouping in accordance with Yugoslav law.

Serbian authorities are currently considering some changes in the accounting laws which are primarily focused on improving the transparency of financial information. Companies are classified into three categories (small, medium and large) in accordance with the Accounting Law (based on number of employees, revenues and assets). Only financial services, large and medium size companies are subject to audit, which has to be carried out by a local authorized auditing firm.

Medium size companies with equity of less than 1 million USD are exempted from audit requirements in 2002 and 2003.

The Serbian authorities are currently considering some changes in the accounting and auditing laws. This is an essential step towards the creation of an appropriate investment climate in Serbia as the current legal framework and practices do not provide sufficient reliable financial information to the foreign investors and other stakeholders (banks, suppliers, state…).

4.1.2 Yugoslav Accounting Regulations and International Accounting Standards

The financial statements produced under International Accounting Standards are unlikely to be compliant with the accounting standards that are legally required in Yugoslavia for taxation purposes (often called statutory accounts). Therefore, the statutory accounts are driven by taxation legislation for calculating corporate tax charges and IAS financial statements represent a disclosure to the various stakeholders about financial results and operations of the business. It is, therefore, clear that the statutory (tax driven) accounts may be different from the International Accounting Standards (business driven) accounts. It is not unusual for widely different results to be disclosed which are still correct and appropriate under the relevant regulations.
4.1.3 Yugoslav Accounting Treatment of Factoring

Yugoslav Law on Accounting or any other law does not specifically prescribe the accounting treatment applicable for factoring, as such transactions are still not widely spread in Yugoslavia. The accounting treatment that could be applied is the one that is usually applied for the assignment of receivables.

Yugoslav Law on Accounting defines short-term receivables as receivables due in less than one year.

Under Yugoslav laws, all short-term assets and liabilities are recognized in the balance sheet. They are valued at their nominal value. Enterprises may more specifically regulate the subject of valuation of receivables by their enactments, within the previously defined framework.

Under IAS 39, all financial assets and financial liabilities are recognized on the balance sheet, including all derivatives. They are initially measured at cost, which is the fair value of whatever was paid or received to acquire the financial asset or liability.

Under Yugoslav accounting regulations, the transfer of receivables is accounted for at the date the transfer is officially made by executing bank payment orders (for crediting/debiting the old and new creditors’ bank account).

Under IAS 39, an enterprise should recognize normal purchases and sales of financial assets in the market place either at trade date or settlement date. Certain value changes between trade and settlement dates are recognized for purchases if settlement date accounting is used.

Under Yugoslav accounting regulations, transaction costs are not included in the initial measurement of financial instruments.

Under IAS 39, transaction costs should be included in the initial measurement of all financial instruments.

Under Yugoslav accounting regulations, the underlying principle of accounting is the historical cost principle. Receivables are valued at their nominal value and are not remeasured to their fair value.

Under IAS 39, subsequent to initial recognition, all financial assets are remeasured to fair value.

Under Yugoslav accounting regulations, the value of receivables can be indirectly decreased by the amount of probable uncollectability and directly decreased if the uncollectability is legally documented.

Under IAS 39, an enterprise should measure receivables that it has originated and that are not held for trading at amortized cost, less reductions for impairment or uncollectibility. The enterprise need not demonstrate an intent to hold originated receivables to maturity.

Yugoslav laws do not specifically determine when control over a financial asset or liability has been transferred to another party. Under The Law on Legal Obligations, the assignment of receivables comes into full effect at the moment the debtor is notified of the assignment and that moment can be identified as the moment that the new creditor takes control over the receivable.

Under IAS 39 establishes conditions for determining when control over a financial asset or liability has been transferred to another party. For financial assets a transfer normally would be recognized if (a) the transferee has the right to sell or pledge the asset and (b) the transferor does not have the right to reacquire the transferred assets.

Under Yugoslav laws, short-term receivables in foreign currency are denominated into Dinars at the rates of exchange prevailing at the transaction date. They are revalued at the exchange
Feasibility Study - Factoring

rates prevailing at the balance sheet date. Unrealised exchange gains and losses are taken to balance sheet in revaluation effect. Realised exchange gains and losses are recognised in income when they arise.

Under IAS 21, foreign currency short term receivables should be accounted for by applying the exchange rate in effect at the transaction date. Foreign currency monetary assets and liabilities should be translated at the closing rate at the balance sheet date. Exchange differences on monetary items should, as a general rule, be recognized in income when they arise, except: when IAS 21 and IAS 39 allow a different treatment under hedge accounting, and in some instances when there is a severe devaluation of the currency between purchase and settlement date for an asset.

According to Yugoslav accounting regulations companies can stipulate in their own enactments the provisioning for bad debts. Banks and financial organisations are obliged to reduce the value of their matured investments and loans for uncollected amounts within 90 days from maturity date. However, Yugoslav tax legislation restricts the ability of a company to fully provide for bad debts in any given period e.g. a court action may be needed before a debt can be fully written off.

Under IAS, a standard policy can be fixed - such as for instance all receivables over 180 days overdue can fully be provided.

4.2 Tax Issues

4.2.1 General

The tax system in FR Yugoslavia is regulated at the federal level and at the level of the Republics (Serbia and Montenegro). The Federal State has competence in defining the kind of taxes that the republics may introduce and its basic elements. The detailed tax regulation, collection and control of tax compliance is in the competence of the Republics.

The tax year in Yugoslavia is the calendar year. The taxpayers are both residents and non-residents.

Yugoslav tax laws do not stipulate factoring in any specific way. There four taxes that may affect factoring in Yugoslavia:

- Financial transactions tax;
- Sales tax on goods;
- Sales tax on services;
- Excise duties.

4.2.2 Tax on financial transactions

Factoring will also be effected by the tax on financial transactions. All financial transactions in Yugoslavia within the payment operations, such as transfer order payments, clearing payments, barter trade, other payments from accounts, endorsement, assignment, etc. are subject to the tax. The taxpayer is a legal entity and an entrepreneur. The rates are:

<table>
<thead>
<tr>
<th>Tax Base</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transactions up to 50.000 Dinars</td>
<td>0,41%</td>
</tr>
<tr>
<td>Transactions up to 50.000 do 100.000 Dinars</td>
<td>0,37%</td>
</tr>
<tr>
<td>Transactions up to 100.000 do 500.000 Dinars</td>
<td>0,34%</td>
</tr>
<tr>
<td>Transactions up to 500.000 do 1.000.000 Dinars</td>
<td>0,30%</td>
</tr>
<tr>
<td>Transactions up to 1.000.000 do 5.000.000 Dinars</td>
<td>0,27%</td>
</tr>
<tr>
<td>Transactions up above 5.000.000 Dinars</td>
<td>0,22%</td>
</tr>
</tbody>
</table>
As of 28th June 2002, transfer of securities is exempted from this tax. However, since the Law on Securities does not identify invoices as being a form of securities, this exemption will not apply to factoring. Thus, every assignment of receivable as well as any and all further payments will be effected by this tax. The taxpayers will be both the old creditor, the factor as well as the debtor.

4.2.3 Sales tax on services

In Yugoslavia, factoring will be effected by the sales tax on services. Since, a sales tax is charged on all services, except for export of services, health, cultural, educational, scientific, social welfare services, public utility services. The taxable base is the commission for provided services. The single-rate is 20%. Therefore, the factoring commission will be taxed at the rate of 20%.

Tax exemptions that may effect factoring are services performed abroad and exporting services.

Interest on advances will not be taxable since interest is not taxable in Yugoslavia, except interest on loans whose rates are, on the contracting date, higher than the retail price index increased by 0.5%.

4.2.4 Sales tax on goods

Factoring in Yugoslavia may also be effected by a single-stage tax levied at the retail level on supplies of goods. The taxpayer is the seller of the goods. Only cigarettes, alcoholic beverages and coffee are subject to the multi-stage sales tax ("mini-VAT"). The taxable base is the sale price of goods stated in the invoice, or the custom value of imported goods. The single-rate sales tax on goods is 20%. The sales tax is not charged if the goods are imported or sold to the customer for the purposes of further sales or production.

Some products are tax exempt (for example, export of products, certain publications, bread, milk, cooking oil, sugar, computer equipment, natural gas, school books).

4.2.5 Excise Duties

Excise duties are levied on producers and importers of the following goods: oil derivatives, tobacco products, alcoholic beverages, alcohol-ethanol, coffee, soft drinks, food salt and luxurious products (i.e. products containing more than 2% of gold, 50% or more of silver, precious stones, furs, goods from reptile's leather, etc.). Oil derivatives and coffee imported by international humanitarian organizations, and alcohol - ethanol used for medical purposes are tax-exempt. The ad valorem rates are valid only for luxurious products (i.e. 20%, and 30%). The excises on other excisable goods are levied as specific ones (based on quantity). The amounts of excises are adjusted on a quarterly basis in line with the evolution of the retail price index.

4.2.6 Stamp duty

There are no stamp duties which would effect factoring in Yugoslavia. For the assignment of a receivable to be legal it is not needed to pay any stamp duties in Yugoslavia.
Example of accounting treatment per Yugoslav law for old creditor (transferor):

**Balance sheet**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade receivables (for the amount of assigned receivable at invoiced value)</td>
<td>400.000</td>
</tr>
<tr>
<td>Cash and cash equivalents (for payment from factor)</td>
<td>388.000</td>
</tr>
</tbody>
</table>

**Income Statement**

Loss on transfer of receivables (for 3% charges) 12.000

FOR NEW CREDITOR (TRANSFEREE):

**Balance sheet**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other short-term receivables (for transfered receivables at invoiced value)</td>
<td>400.000</td>
</tr>
<tr>
<td>Cash and cash equivalents (for payment to old creditor)</td>
<td>388.000</td>
</tr>
<tr>
<td>Cash and cash equivalents (for collection from the debtor)</td>
<td>400.000</td>
</tr>
<tr>
<td>Other short-term receivables (for collection from the debtor)</td>
<td>400.000</td>
</tr>
</tbody>
</table>

**Income Statement**

3% commission 12.000

---

**Major Differences Between IAS 39 and Yugoslav Regulations**

<table>
<thead>
<tr>
<th>IAS 39</th>
<th>Yugoslav regulations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>IASC: Definitions</strong></td>
<td><strong>YR: Definitions</strong></td>
</tr>
<tr>
<td>A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise.</td>
<td>Not defined</td>
</tr>
<tr>
<td>A financial asset is cash, a contractual right to receive cash or another financial asset from another enterprise, a contractual right to exchange financial instruments with another enterprise under conditions that are potentially unfavorable, or an equity instrument of another enterprise.</td>
<td>Not defined</td>
</tr>
<tr>
<td>A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise, or to exchange financial instruments with another enterprise under conditions that are potentially unfavorable.</td>
<td>Not defined</td>
</tr>
<tr>
<td>If an enterprise has a contractual obligation that it can settle either by paying out a financial assets or its own equity securities, and if the number of equity securities required to settle the obligation varies with changes in their fair value so that the total fair value of the equity securities paid always equals the amount of the contractual obligation, the obligation should be accounted for as a financial liability, not as equity.</td>
<td>Not defined</td>
</tr>
<tr>
<td>A derivative is a financial instrument—(a) - whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange</td>
<td>Derivatives are futures, swaps and options</td>
</tr>
</tbody>
</table>
rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the ‘underlying’); (b) - that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and (c) - that is settled at a future date.

<table>
<thead>
<tr>
<th>IASC: Initial Recognition and Measurement</th>
<th>YR: Initial Recognition and Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>All financial assets and financial liabilities are recognized on the balance sheet, including all derivatives</td>
<td>Same</td>
</tr>
<tr>
<td>Initially, they are measured at the fair value of whatever was paid or received to acquire the financial asset or liability.</td>
<td>Securities are measured at the lower of cost or market value</td>
</tr>
<tr>
<td>Transaction costs are included in the initial measurement of all financial instruments.</td>
<td>YR do not address transaction costs.</td>
</tr>
<tr>
<td>An enterprise will recognize normal purchases and sales of securities in the market place either at trade date or settlement date. If settlement date accounting is used for purchases, IAS 39 requires recognition of certain value changes between trade and settlement dates so that the income statement effects are the same for all enterprises.</td>
<td>YR does not address trade date vs. settlement date. Value change between trade and settlement dates may be included in or excluded from measurement of net income.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All financial assets held for trading</td>
<td>Financial assets held for trading are not separately disclosed</td>
</tr>
<tr>
<td>All debt securities, equity securities, and other financial assets that are not held for trading but nonetheless are available for sale – except those unquoted equity securities whose fair value cannot be measured reliably by another means are measured at cost subject to an impairment test.</td>
<td>All securities are valued at the lower of cost or market value</td>
</tr>
<tr>
<td>All derivative assets and derivative liabilities, unless they are linked to and must be settled by an unquoted equity whose fair value cannot be measured reliably</td>
<td>Not defined</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Originated loans and receivables</td>
<td>At nominal value</td>
</tr>
<tr>
<td>Enterprise does not have to demonstrate intent and ability to hold to maturity for originated loans and receivables</td>
<td>Same</td>
</tr>
<tr>
<td>Certain other fixed-maturity investments that the enterprise intends and has the ability to hold to maturity</td>
<td>Same</td>
</tr>
<tr>
<td>Strict tests for held-to-maturity</td>
<td>None</td>
</tr>
<tr>
<td>An intended or actual sale of a held-to-maturity security due to a non-recurring and not reasonably anticipated circumstance beyond the enterprise's control does not call into question the enterprise's ability to hold its remaining portfolio to maturity.</td>
<td>Not defined</td>
</tr>
<tr>
<td>Tainting of held-to-maturity category by early sale causes all remaining held-to-maturity assets to be measured at fair value.</td>
<td>Not defined</td>
</tr>
<tr>
<td>If an enterprise is prohibited from classifying financial assets as held-to-maturity because it has actually sold some such assets before maturity, that prohibition expire at the end of the second financial year following the premature sales.</td>
<td>Not defined</td>
</tr>
<tr>
<td>Topic</td>
<td>Description</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Unquoted equity instruments</strong></td>
<td>Such as ordinary shares whose fair value cannot be reliably measured, along with derivatives that are linked to and must be settled by delivery of such unquoted equities.</td>
</tr>
<tr>
<td><strong>Write-down</strong></td>
<td>Against net profit or loss for impairment or uncollectibility if recoverable amount of a financial asset carried at cost exceeds carrying amount.</td>
</tr>
<tr>
<td><strong>Reversal</strong></td>
<td>Of write-down into net profit or loss if fair value recovers.</td>
</tr>
<tr>
<td><strong>IASC: Subsequent Measurement – Financial Liabilities</strong></td>
<td>All financial liabilities are measured at original recorded amount less principal repayments and amortization except for derivative liabilities and liabilities held for trading (such as securities borrowed by a short seller), which are remeasured to fair value.</td>
</tr>
<tr>
<td><strong>IASC: Reporting Fair Value Changes</strong></td>
<td>For those financial assets and liabilities that are remeasured to fair value, an enterprise has a single, enterprise-wide option to either: (a) recognize the entire adjustment in net profit or loss for the period; or (b) recognize in net profit or loss for the period only those changes in fair value relating to financial assets and liabilities held for trading, with value changes in non-trading items reported in equity until the financial asset is sold, at which time the realized gain or loss is reported in net profit or loss.</td>
</tr>
<tr>
<td><strong>IASC: Derecognition</strong></td>
<td>A financial asset is derecognised if the transferee has the right to sell or pledge the asset; and the transferor does not have the right to reacquire the transferred assets. (However, such a right does not prevent derecognition if either the asset is readily obtainable in the market or the reacquisition price is fair value at the time of reacquisition.)</td>
</tr>
<tr>
<td><strong>IASC: Hedge Accounting</strong></td>
<td>Hedge accounting is permitted in certain circumstances, provided that the hedging relationship is clearly defined, measurable, and actually effective. Use of noncash hedging instruments is restricted to exposure to hedges of any risk of gain or loss from changes in foreign currency exchange rates arising in fair value hedges, cash flow hedges, or hedges of a net investment in a foreign operation. Three types of hedges are defined: Fair value hedge Cash flow hedge Hedge of a net investment in a foreign entity Fair value hedge definition: a hedge of the exposure to changes in the fair value of a recognized asset or liability (such as a hedge of exposure to changes in the fair value of fixed rate debt as a result of changes in interest rates).</td>
</tr>
</tbody>
</table>
However, a hedge of an unrecognized firm commitment to buy or sell an asset at a fixed price in the enterprise’s reporting currency is accounted for as a cash flow hedge.

<table>
<thead>
<tr>
<th>Description</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fair value hedge accounting:</strong></td>
<td>The gain or loss from remeasuring the hedging instrument at fair value is recognized immediately in net profit or loss. At the same time, the gain or loss on the hedged item attributable to the risk being hedged adjusts the carrying amount of the hedged item and is recognized immediately in net profit or loss.</td>
</tr>
<tr>
<td><strong>Cash flow hedge accounting:</strong></td>
<td>The portion of the gain or loss on the effective hedging instrument is recognized initially directly in equity. Subsequently, that amount is included in net profit or loss in the same period or periods during which the hedged item affects net profit or loss (for example, through cost of sales, depreciation, or amortization).</td>
</tr>
<tr>
<td><strong>Cash flow hedge accounting:</strong></td>
<td>For a hedge of forecasted sales, the gain or loss on the hedging instrument will be included in net profit or loss in the same period as the sales revenue is recognized.</td>
</tr>
<tr>
<td><strong>Cash flow hedge accounting:</strong></td>
<td>For a hedge of a forecasted asset and liability acquisition, the gain or loss on the hedging instrument will adjust the basis (carrying amount) of the acquired asset or liability. The gain or loss on the hedging instrument that is included in the initial measurement of the asset or liability is subsequently included in net profit or loss when the asset or liability affects net profit or loss (such as in the periods that depreciation expense, interest income or expense, or cost of sales is recognized).</td>
</tr>
<tr>
<td><strong>Hedge of a net investment in a foreign entity:</strong></td>
<td>accounted for same as a cash flow hedge.</td>
</tr>
<tr>
<td><strong>Specific designation:</strong></td>
<td>The enterprise must designate a specific hedging instrument as a hedge of a change in value or cash flow of a specific hedged item, rather than as a hedge of an overall net balance sheet position. However, the approximate income statement effect of hedge accounting for an overall net position can be achieved, in some cases, by designating part of one of the underlying items as the hedged position.</td>
</tr>
</tbody>
</table>
Major Differences Between the Practical Implementation of Yugoslav Regulations and International Accounting Standards

<table>
<thead>
<tr>
<th>Accounting Component</th>
<th>Yugoslav regulations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Consolidation</strong></td>
<td></td>
</tr>
<tr>
<td>1.1. Basic of Consolidation</td>
<td>Consolidated annual financial statements for entities controlling one or more legal entities incorporate financial statements of a parent company and all of its subsidiaries.</td>
</tr>
<tr>
<td><strong>2. Fixed Assets</strong></td>
<td></td>
</tr>
<tr>
<td>2.1. Property, plant and equipment</td>
<td>Historical cost less accumulated depreciation subject to revaluation by applying the officially published revaluation coefficients, based on the increase in the retail price index.</td>
</tr>
<tr>
<td>2.2. Financial leases</td>
<td>There are no specific regulations concerning financial leases</td>
</tr>
<tr>
<td>2.3. Disposals</td>
<td>Gains or losses from disposals are calculated at revalued book value, and included in P/L. Losses are not directly tax deductible, but can be net off against capital gain.</td>
</tr>
<tr>
<td>2.4. Depreciation</td>
<td>Useful lives are typically longer than in IAS Revaluation of depreciation is obligatory</td>
</tr>
<tr>
<td>2.5. Investments</td>
<td>Classified as a long-term investment but may be classified as current assets and recorded at revalued nominal value.</td>
</tr>
</tbody>
</table>
4.3 Analyses and recommendations

None of the laws are obstacles for setting up factoring in Serbia and Montenegro.

Alongside banks, factoring services can also be provided by a “general trading company” or an “exchange intermediary”. Given that the required minimum share capital of a Bank is 10 million EURO, it is recommended to establish a factoring company as “other exchange intermediary” or more precisely as a “discount firm” with equity of EURO 2 million, in order to fulfil the requirements of Factors Chain International.

It is highly recommendable to form a joint venture between a local bank and an experienced European factoring company. A participation of IFC in share capital should be appreciated.

4.3.1 A view on strategy and business policy of a new factoring company

Objectives of New Factoring Companies

Provide a new type of financial service to the Serbian and Montenegro business community;
Become a respectful financial institution in trade finance;
Help local bank partners to maintain the image of a modern, fast reacting, customer oriented institute, ready to support the needs of corporate clients all over Serbia and Montenegro with a special emphasis on international operations;
Fulfil the strategic objective of international factoring partners of being present in the Serbian and Montenegro market.

Goals

Create a regular customer base of exporting companies;
Approach international factoring markets, establishing correspondent relationships with leading factoring organisations;
Achieve export factoring turnover of:
  - EURO 5 million in 2004
  - EURO 15 million in 2005
  - EURO 30 million in 2006
Reach the break-even point in the second full business year
Obtain membership of Factors Chain International

Scope of Business

Initially, new factoring companies should be engaged in EXPORT - factoring. Domestic and Import factoring may be performed on a case-to-case basis.

Pricing policy

1. Interest rate

Interest rates for non-recourse factoring should be comparable to the rates prevailing and charged by Serbian banks. These rates can be increased depending on the terms of payment, volume of business and possibilities for refinancing.

2. Factoring fee

The overall factoring fee is usually between 1% and 2% and is charged on 100% value of the receivables turned over to the export factor.
Factoring fees may vary depending on volume of business, payment terms of receivables, country of destination of exports, etc.
3. Handling fee
EURO 6 – 12 per invoice is usually charged to the exporter as a handling fee.

Funding policy
- own funds
- refinancing with import factors
- domestic and foreign money markets
The funding policy shall be guided by policy of maximising the net interest margin.

Risk policy
1. Financing
The newly established factoring company should normally perform its operations on a non-recourse basis, provided the payment (del credere) risk is transferred to an import factor.
2. Collection
The company should collect receivables on a risk free basis. The payment risk will be taken only if transfer of risk to import factor has been agreed, or if risk remains with the seller.
Performance risk is the sole responsibility of the seller (exporter). Financial situation of the seller should be monitored frequently.
3. Currency risk
The company should minimise and neutralise currency risk by transferring this risk to clients. Furthermore, exporters should be financed in the same currency as the currency of the underlying export receivables.
4. Interest Rate Risk
The company should minimise or neutralise interest rate risk by matching the interest rate type of specific transaction financed with the type of interest rate paid for refinancing funds.
5. Country risk
Since the majority of export factoring will, as expected, involve factors and buyers in countries with insignificant country risk, no special precautionary measures are being contemplated with a view of protecting the company from this kind of risk.
However, in case of exports to countries with higher country risk, the company should to minimise exposure by extending the sellers prefinancing and other lines only with shorter than average tenor.
6. Import Factor Risk
In order to minimise this kind of risk, the company should establish and maintain business relations only with selected factoring organisations and particularly with reputable FCI members.
5 STRATEGY AND BUSINESS POLICY

5.1 The Mission

Providing export orientated Serbian companies with a custom made trade finance service with a view of satisfying the interests of the founding shareholders.

5.1.1 Objectives

The objectives of the newly created company could broadly be defined as follows:

- provide a new financial service to the Serbian business community
- become a respectful financial institution in Serbia in the field of trade finance
- help the local bank partners to maintain the image of a modern, fast reacting, customer oriented institute, ready to support the needs of corporate clients all over Serbia with a special emphasis on international operations
- fulfil the strategic objective of the international factoring partner of being present in the Serbian market

5.1.2 Goals

- establish an adequate organisational structure, standard procedures and control mechanism
- create a regular customer base of exporting companies
- approach international factoring markets, establishing correspondent relationships with leading factoring organisations
- achieve export factoring turnover of
  - EURO 5 million in 2004
  - EURO 15 million in 2005
  - EURO 30 million in 2006
- create conditions for the introduction of domestic factoring and import factoring after successful implementation of export factoring
- reach the break-even point in the second full business year
- obtain membership of Factors Chain International

5.1.3 Human Resources Plan

In the initial period of the new established factoring company, the number of employees shall be minimised to those, which are considered necessary for undisturbed performance of the activities foreseen.

These will include:
- a single managing director
- manager marketing and customer relations
In addition, a senior factoring officer shall be seconded for a time period of at least two years by the international factoring shareholding partner.

Provided satisfactory growth of business, the employment of an additional factoring officer may be considered, with the objective of assisting the senior factoring officer to carry out the tasks related to handling the factoring documentation.

The payment scheme shall be based on tariff-terms comparable to those of the Serbian shareholding bank and shall include salary and obligatory health and pension insurance.

### 5.1.4 Scope of business

The new established factoring company shall primarily engage in EXPORT-factoring at the beginning. Domestic and Import factoring may be performed on a case to case basis upon prior approval by the Supervisory Board.

The activities within Export Factoring shall include:

- Purchasing of receivables (unsecured claims resulting from sale of goods and rendering of services on open account)

- **Category of goods:** Consumer goods, components and semi-finished products for manufacturing, tourism and transportation, services, catering, pharmaceutics, metal goods, light machinery, etc.

- **Max. payment term:** 90 days

- **Max. prefinancing to seller (Exporter):** 80% of the outstanding balance of not overdue claims.

- Sellers have to include in a factoring agreement all deliveries to an individual buyer or even to all buyers in a particular country of destination.

- **Purchasing on a case by case basis of other short-term claims,** resulting from export of goods or services
  
  This includes claims secured by L/C, bankers acceptance, draft, promissory note etc. if issued and/or confirmed (aval, acceptance) by a prime international bank.
5.2 **Pricing policy**

- **Interest rate**

In the case of non-recourse factoring and therefore payment risk transferred to a foreign import factor [for undisputed deliveries], the interest rate charged to the seller (exporter) shall be comparable to the rates prevailing and charged by Serbian banks to their borrowers.

The rate can be increased at the discretion of the managing director, if average terms of payment exceed the usual 30, 60, 90 days, depending on the volume of business and on the possibilities of refinancing the business.

- **Factoring fee**

The factoring fee paid by the seller (exporter) consists of the part charged by the import factor for risk-taking and collection on the one hand and the part marked up by the export factor on the other hand. The overall factoring fee amounts usually between 1% and 2% and is charged on 100% value of the receivables turned over to the export factor.

The factoring fee structure shall be different, depending on volume of business and payment terms of the receivables.

The factoring fee can vary also, depending on the country of destination of exports, e.g. when selling to countries where import factors usually charge higher fees compared to average.

### 5.2.1 Handling fee

EURO 6 – 12 per invoice is usually charged to the exporter as a handling fee.

**Funding policy**

- own funds
- refinancing with import factors
- domestic and foreign money markets

The funding policy shall be guided by policy of maximising the net interest margin.

5.3 **Risk policy**

- **Financing**

With regard to the receivables financing, the new established factoring company shall normally perform its operations on a non-recourse basis, provided that the payment (del credere) risk is transferred to an import factor.
The company in principle shall not finance those export transactions, which are not covered by import factors taking over of payment risk. In exceptional cases such transactions may be carried out only under recourse to the seller and further provided that such company (seller) is considered prime risk.

Collection
The company shall perform collection of receivables on a risk free basis. The payment risk will be taken only if transfer of risk to import factor had been agreed, or if risk remains with the seller. Deviations from this rule can be made only in exceptional cases.

Performance risk is the sole responsibility of the seller (exporter). For covering this potential risk the financial situation of the seller shall be monitored frequently.

Currency risk
The company shall try to minimise and neutralise currency risk resulting from carrying out its business operations by insisting on conclusion of such factoring agreements with its clients, according to which currency risk (profit or loss due to the appreciation or depreciation of the local currency in respect to foreign currencies) will be transferred on them. Furthermore exporters shall be financed in the same currency as the currency of the underlying export receivables.

The company shall further try to match the assets and liabilities currency structure with the objective to avoid currency gaps and the risk resulting therefrom.

Interest Rate Risk
The company shall try to minimise or neutralise interest rate risk by matching the interest rate type of specific transaction financed with the type of interest rate paid for refinancing funds.

Country risk
Since the overwhelming majority of transactions (export factoring) will, as expected, involve partners (factors and buyers) in countries with insignificant country (political, economic) risk, no special precautionary measures are being contemplated with a view of protecting the company from this kind of risk. However in the case of exports to countries with higher country risk, the company shall try to minimise exposure by extending the sellers prefinancing and other lines only with shorter than average tenor.

Import Factor Risk
In order to minimise this kind of risk, the company shall seek to establishing and maintaining business relations with selected factoring organisations only and particularly with reputable FCI members.
5.4 Analyses and Recommendations

The Law on Obligational Relations as well as the Law on Banks and other Financial Institutions are not setting up obstacles for factoring. The Law on Foreign Exchange restricts foreign operations in FX to “Authorised Banks”.

The Law on Banks and other Financial Institutions, art 22. para 1, item 2 regulates that banks may ALSO deal in “buying and collecting of receivables” so establishing that factoring [buying and collecting of receivables] is not an exclusive banking business.

Therefore factoring services can also be provided by a “general trading company” or an “exchange intermediary”.

As the minimum share capital of a Bank is required to be 10 million EURO it is recommended to establish a factoring company as “other exchange intermediary” more precisely as a “discount firm”.

The legal structure, following the Company Act should be a limited liability company with an equity of EURO 2 million to fulfil the requirements of Factors Chain International to be accepted as an associate member. This is essential for the introduction of the more riskless export factoring business.

It is highly recommended to form a joint venture between an interested local bank [with at least “medium authorisation”] and an experienced European factoring company. A participation of IFC in the share capital should be welcomed.

Parallel to the establishing of the “exchange intermediary”, a campaign should be started to get the support from the Ministry of Finance, the Ministry of International Economic Relations and the National Bank to regulate the factoring business.

This should result in defining factoring companies as “financial institutions” needing for their business a special license. This license should be provided either by the Ministry of Finance or the National Bank. For the start up period a lower share capital [e.g. 2 million EURO] shall be sufficient. The “financial institutions” shall be subject to the supervision by the National Bank. The additional workload for the Banking supervision is not a lot, because of the restricted business [prepaying the purchaseprice] of the factoring companies.

The consultant experienced support when discussing these topics with the respective organisations.

Improvements are necessary on the collection part of the factoring business. Payment moral is not on good level, court procedures in case of non payment by the debtors are at the moment not satisfying as they are lengthy and ineffective. The Law on Compulsory Composition, Bankruptcy and Liquidation is also ineffective, slow and not in favour of the creditors, especially the unsecured. Amendment or a new law on bankruptcy is hopefully in preparation.
6 UNIDROIT CONVENTION ON INTERNATIONAL FACTORING (OTTAWA, 28 MAY 1988)

THE STATES PARTIES TO THIS CONVENTION,
CONSCIOUS of the fact that international factoring has a significant role to play in the development of international trade,
RECOGNISING therefore the importance of adopting uniform rules to provide a legal framework that will facilitate international factoring, while maintaining a fair balance of interests between the different parties involved in factoring transactions,
HAVE AGREED as follows:

CHAPTER I - SPHERE OF APPLICATION AND GENERAL PROVISIONS

Article 1
1. - This Convention governs factoring contracts and assignments of receivables as described in this Chapter.
2. - For the purposes of this Convention, "factoring contract" means a contract concluded between one party (the supplier) and another party (the factor) pursuant to which:
(a) the supplier may or will assign to the factor receivables arising from contracts of sale of goods made between the supplier and its customers (debtors) other than those for the sale of goods bought primarily for their personal, family or household use;
(b) the factor is to perform at least two of the following functions:
   - finance for the supplier, including loans and advance payments;
   - maintenance of accounts (ledgering) relating to the receivables;
   - collection of receivables;
   - protection against default in payment by debtors;
(c) notice of the assignment of the receivables is to be given to debtors.
3. - In this Convention references to "goods" and "sale of goods" shall include services and the supply of services.
4. - For the purposes of this Convention:
(a) a notice in writing need not be signed but must identify the person by whom or in whose name it is given;
(b) "notice in writing" includes, but is not limited to, telegrams, telex and any other telecommunication capable of being reproduced in tangible form;
(c) a notice in writing is given when it is received by the addressee.

Article 2
1. - This Convention applies whenever the receivables assigned pursuant to a factoring contract arise from a contract of sale of goods between a supplier and a debtor whose places of business are in different States and:
(a) those States and the State in which the factor has its place of business are Contracting States; or
(b) both the contract of sale of goods and the factoring contract are governed by the law of a Contracting State.
2. - A reference in this Convention to a party's place of business shall, if it has more than one place of business, mean the place of business which has the closest relationship to the relevant contract and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of that contract.

Article 3
1. - The application of this Convention may be excluded:
(a) by the parties to the factoring contract; or
(b) by the parties to the contract of sale of goods, as regards receivables arising at or after the time when the factor has been given notice in writing of such exclusion.
2. - Where the application of this Convention is excluded in accordance with the previous paragraph, such exclusion may be made only as regards the Convention as a whole.
Article 4
1. - In the interpretation of this Convention, regard is to be had to its object and purpose as set forth in the preamble, to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.
2. - Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.

CHAPTER II - RIGHTS AND DUTIES OF THE PARTIES

Article 5
As between the parties to the factoring contract:
(a) a provision in the factoring contract for the assignment of existing or future receivables shall not be rendered invalid by the fact that the contract does not specify them individually, if at the time of conclusion of the contract or when they come into existence they can be identified to the contract;
(b) a provision in the factoring contract by which future receivables are assigned operates to transfer the receivables to the factor when they come into existence without the need for any new act of transfer.

Article 6
1. - The assignment of a receivable by the supplier to the factor shall be effective notwithstanding any agreement between the supplier and the debtor prohibiting such assignment.
2. - However, such assignment shall not be effective against the debtor when, at the time of conclusion of the contract of sale of goods, it has its place of business in a Contracting State which has made a declaration under Article 18 of this Convention.
3. - Nothing in paragraph 1 shall affect any obligation of good faith owed by the supplier to the debtor or any liability of the supplier to the debtor in respect of an assignment made in breach of the terms of the contract of sale of goods.

Article 7
A factoring contract may validly provide as between the parties thereto for the transfer, with or without a new act of transfer, of all or any of the supplier's rights deriving from the contract of sale of goods, including the benefit of any provision in the contract of sale of goods reserving to the supplier title to the goods or creating any security interest.

Article 8
1. - The debtor is under a duty to pay the factor if, and only if, the debtor does not have knowledge of any other person's superior right to payment and notice in writing of the assignment:
(a) is given to the debtor by the supplier or by the factor with the supplier's authority;
(b) reasonably identifies the receivables which have been assigned and the factor to whom or for whose account the debtor is required to make payment; and
(c) relates to receivables arising under a contract of sale of goods made at or before the time the notice is given.
2. - Irrespective of any other ground on which payment by the debtor to the factor discharges the debtor from liability, payment shall be effective for this purpose if made in accordance with the previous paragraph.

Article 9
1. - In a claim by the factor against the debtor for payment of a receivable arising under a contract of sale of goods the debtor may set up against the factor all defences arising under that contract of which the debtor could have availed itself if such claim had been made by the supplier.
2. - The debtor who has such a right to recover from the supplier a sum paid to the factor in respect of a receivable shall nevertheless be entitled to recover that sum from the factor to the extent that:
(a) the factor has not discharged an obligation to make payment to the supplier in respect of that receivable; or
(b) the factor made such payment at a time when it knew of the supplier's non-performance or defective or late performance as regards the goods to which the debtor's payment relates.

CHAPTER III - SUBSEQUENT ASSIGNMENTS

Article 11
1. - Where a receivable is assigned by a supplier to a factor pursuant to a factoring contract governed by this Convention:
   (a) the rules set out in Articles 5 to 10 shall, subject to sub-paragraph (b) of this paragraph, apply to any subsequent assignment of the receivable by the factor or by a subsequent assignee;
   (b) the provisions of Articles 8 to 10 shall apply as if the subsequent assignee were the factor.
2. - For the purposes of this Convention, notice to the debtor of the subsequent assignment also constitutes notice of the assignment to the factor.

Article 12
This Convention shall not apply to a subsequent assignment which is prohibited by the terms of the factoring contract.

CHAPTER IV - FINAL PROVISIONS

Article 13
1. - This Convention is open for signature at the concluding meeting of the Diplomatic Conference for the Adoption of the Draft Unidroit Conventions on International Factoring and International Financial Leasing and will remain open for signature by all States at Ottawa until 31 December 1990.
2. - This Convention is subject to ratification, acceptance or approval by States which have signed it.
3. - This Convention is open for accession by all States which are not signatory States as from the date it is open for signature.
4. - Ratification, acceptance, approval or accession is effected by the deposit of a formal instrument to that effect with the depositary.

Article 14
1. - This Convention enters into force on the first day of the month following the expiration of six months after the date of deposit of the third instrument of ratification, acceptance, approval or accession.
2. - For each State that ratifies, accepts, approves, or accedes to this Convention after the deposit of the third instrument of ratification, acceptance, approval or accession, this Convention enters into force in respect of that State on the first day of the month following the expiration of six months after the date of the deposit of its instrument of ratification, acceptance, approval or accession.

Article 15
This Convention does not prevail over any treaty which has already been or may be entered into.

Article 16
1. - If a Contracting State has two or more territorial units in which different systems of law are applicable in relation to the matters dealt with in this convention, it may, at the time of signature, ratification, acceptance, approval or accession, declare that this Convention is to extend to all its territorial units or only to one or more of them, and may substitute its declaration by another declaration at any time.
2. - These declarations are to be notified to the depositary and are to state expressly the territorial units to which the Convention extends.
3. - If, by virtue of a declaration under this article, this Convention extends to one or more but not all of the territorial units of a Contracting State, and if the place of business of a party is located in that State, this place of business, for the purposes of this Convention, is considered not to be in a Contracting State, unless it is in a territorial unit to which the Convention extends.
4. - If a Contracting State makes no declaration under paragraph 1, the Convention is to extend to all territorial units of that State.

Article 17
1. - Two or more Contracting States which have the same or closely related legal rules on matters governed by this Convention may at any time declare that the Convention is not to apply where the supplier, the factor and the debtor have their places of business in those States. Such declarations may be made jointly or by reciprocal unilateral declarations.
2. - A Contracting State which has the same or closely related legal rules on matters governed by this Convention as one or more non-Contracting States may at any time declare that the Convention is not to apply where the supplier, the factor and the debtor have their places of business in those States.

3. - If a State which is the object of a declaration under the previous paragraph subsequently becomes a Contracting State, the declaration made will, as from the date on which the Convention enters into force in respect of the new Contracting State, have the effect of a declaration made under paragraph 1, provided that the new Contracting State joins in such declaration or makes a reciprocal unilateral declaration.

**Article 18**

A Contracting State may at any time make a declaration in accordance with Article 6(2) that an assignment under Article 6(1) shall not be effective against the debtor when, at the time of conclusion of the contract of sale of goods, it has its place of business in that State.

**Article 19**

1. - Declarations made under this Convention at the time of signature are subject to confirmation upon ratification, acceptance or approval.

2. - Declarations and confirmations of declarations are to be in writing and to be formally notified to the depositary.

3. - A declaration takes effect simultaneously with the entry into force of this Convention in respect of the State concerned. However, a declaration of which the depositary receives formal notification after such entry into force takes effect on the first day of the month following the expiration of six months after the date of its receipt by the depositary. Reciprocal unilateral declarations under Article 17 take effect on the first day of the month following the expiration of six months after the receipt of the latest declaration by the depositary.

4. - Any State which makes a declaration under this Convention may withdraw it at any time by a formal notification in writing addressed to the depositary. Such withdrawal is to take effect on the first day of the month following the expiration of six months after the date of the receipt of the notification by the depositary.

5. - A withdrawal of a declaration made under Article 17 renders inoperative in relation to the withdrawing State, as from the date on which the withdrawal takes effect, any joint or reciprocal unilateral declaration made by another State under that article.

**Article 20**

No reservations are permitted except those expressly authorised in this Convention.

**Article 21**

This Convention applies when receivables assigned pursuant to a factoring contract arise from a contract of sale of goods concluded on or after the date on which the Convention enters into force in respect of the Contracting States referred to in Article 2(1)(a), or the Contracting State or States referred to in paragraph 1(b) of that article, provided that:

(a) the factoring contract is concluded on or after that date; or

(b) the parties to the factoring contract have agreed that the Convention shall apply.

**Article 22**

1. - This Convention may be denounced by any Contracting State at any time after the date on which it enters into force for that State.

2. - Denunciation is effected by the deposit of an instrument to that effect with the depositary.

3. - A denunciation takes effect on the first day of the month following the expiration of six months after the deposit of the instrument of denunciation with the depositary. Where a longer period for the denunciation to take effect is specified in the instrument of denunciation it takes effect upon the expiration of such longer period after its deposit with the depositary.

**Article 23**

1. - This Convention shall be deposited with the Government of Canada.

2. - The Government of Canada shall:

(a) inform all States which have signed or acceded to this Convention and the President of the International Institute for the Unification of Private Law (Unidroit) of:

(i) each new signature or deposit of an instrument of ratification, acceptance, approval or accession, together with the date thereof;
(ii) each declaration made under Articles 16, 17 and 18;

(iii) the withdrawal of any declaration made under Article 19(4);

(iv) the date of entry into force of this Convention;

(v) the deposit of an instrument of denunciation of this Convention together with the
date of its deposit and the date on which it takes effect;

(b) transmit certified true copies of this Convention to all signatory States, to all States acceding to the Convention and to the President of the International Institute for the Unification of Private Law (Unidroit). IN WITNESS WHEREOF the undersigned plenipotentiaries, being duly authorised by their respective Governments, have signed this Convention. DONE at Ottawa, this twenty-eighth day of May, one thousand nine hundred and eighty-eight, in a single original, of which the English and French texts are equally authentic.

7 APPENDICES

7.1 LOR: «ASSIGNMENT OF CLAIMS BY CONTRACT
(ASSIGNMENT OR CESSION)

Subsection 1.
GENERAL PROVISIONS

Article 436. Which Claims May Be Ceded by Contract

(1) A creditor may assign (cede) his claim by a contract entered into with a third person, except a claim whose transfer is not permitted by statute, or which is restricted to creditor's person, or whose very nature is incompatible with transferring to another.

(2) A contract of assignment (cession) shall have no effect for a debtor if he and the creditor have stipulated that the latter shall not be able to assign the claim to another, or that he shall not assign it without the debtor's consent.

Article 437. Accessory Rights

(1) Accessory rights shall pass with the claim to the recipient, such as the right of preferential payment, mortgage, security, rights on the ground of contract with a guarantor, rights to interest, to liquidate damages, and the like.

(2) However, an assignor (a person effecting cession) may deliver the object pledged to the recipient only should the pledger agree; otherwise, it shall remain with the person effecting assignment, to be kept by him for the account of the recipient.

(3) It shall be presumed that due and outstanding interest is assigned (ceded) together with the principal claim.

Article 438. Notifying a Debtor

(1) Consent of debtor shall not be necessary for the assignment of a claim, but the assignor (person effecting cession) shall be bound to notify the debtor of the assignment (cession) effected.

(2) Fulfillment effected to the assignor (person effecting cession) before notification about the assignment (cession) shall be valid and shall exempt the debtor from obligation, but only if he was not aware of the assignment (cession); otherwise, the obligation shall remain valid and he shall be bound to fulfill it to the recipient.

Article 439. Multiple Assignment (Cession)

Should a creditor assign one and the same claim to various persons, the claim shall attach to the recipient being the first notified as such to the debtor by the assignor (person effecting cession) or to the assignee (recipient) who was the first to contact the debtor.
Subsection 2.

RELATIONSHIP BETWEEN A RECIPIENT AND A DEBTOR

Article 440.
(1) An assignee (recipient) shall have the same rights against a debtor otherwise pertaining to the assignor (person effecting cession) against the debtor before the assignment (cession).
(2) A debtor may raise against an assignee (recipient), in addition to objections he has against him, also those which he was able to raise against the assignor (person effecting cession) until the moment of his being notified of the assignment (cession).

Subsection 3.

RELATIONSHIP BETWEEN AN ASSIGNEE (RECIPIENT) AND AN ASSIGOR (PERSON EFFECTING CESSION)

Article 441. Presenting a Document on Debt
(1) An assignor (person effecting cession) shall be bound to present to the assignee (recipient) a debenture bond or some other document evidencing debt, should such be in his possession, as well as other proof on the assigned claim and on accessory rights pertaining thereto.
(2) Should the assignor (person effecting cession) transfer to an assignee (recipient) only a part of the claim, he shall be bound to present to him a certified copy of the debenture bond or of some other document proving the existence of the assigned claim.
(3) The assignor shall be bound, upon the request of assignee, to issue to him a certified certificate on the assignment.

Article 442. Guaranteeing the Existence of a Claim
After an assignment is effected by a contract with consideration, the assignor (person effecting cession) shall guarantee the existence of the claim at the moment of effecting the assignment.

Article 443. Guaranteeing Collectibility
(1) Should this be stipulated, the assignor (person effecting cession) shall guarantee the collectibility of an assigned claim, but only to the amount received from the recipient (assignee), as well as the collectibility of the interest, expenses relating to assignment and expenses of proceedings against the debtor.
(2) A higher degree of liability of the assignor acting in good faith cannot be stipulated.

Subsection 4.

PARTICULAR CASES OF ASSIGNMENT (CESSION) OF CLAIMS

Article 444. Assignment (Cession) Instead of Fulfillment or for Collection
(1) Should a debtor, instead of fulfilling his obligation, assign to a creditor his claim or a part of it, the debtor's obligation shall be terminated up to the amount of the assigned claim by the fact of entering into contract on assignment.
(2) However, should a debtor assign his claim to his creditor only in order to effect payment, his obligation shall be terminated, or reduced, only after the creditor has collected the assigned claim.
(3) In both cases the recipient shall be bound to hand over to the assignor (person effecting cession) everything collected by him over the amount of his claim to the latter.
(4) In case of assignment for the purpose of collection, the debtor of the assigned claim may fulfill his obligation also to the assignor (person effecting cession), even after he has been notified of the assignment.

Article 445. Assignment (Cession) for the Purpose of Guarantee
Should assignment (cession) be effected for the purpose of guaranteeing the assignee's claim against the assignor, the assignee shall be bound to proceed as a good businessman or good head of
household, in seeing to the collection of the assigned claim; after the collection and after deducting the amount necessary for settling his own claim against the assignor (person effecting cession), he shall hand over the difference to him.»

7.2 LOR: III. REPUDIATION OF A CONTRACT DUE TO NON-PERFORMANCE

Article 124. Rights of One Party after the Other Fails to Perform His Obligation

With bilateral contracts, if one party fails to perform his obligation, the other party, unless something else has been determined, may request performance of the obligation or, under the terms specified in subsequent articles, may repudiate the contract by simple statement, should rescission of contract be not effected on the ground of law, and in any case, such party shall be entitled to damages.

Article 125. Where Performance within a Time Limit is an Essential Element of Contract

(1) Should performance within a time limit be an essential element (term) of contract, and the defaulter fails to meet his commitment within such time limit, the contract shall be repudiated on the ground of law.

(2) However, the first party may maintain the enforceability of the contract by immediately informing the defaulter, after the expiration of the time limit, that he is going to request performance of the contract.

(3) If the first party's request for performance has not been answered within a reasonable time limit, he may state his intention to repudiate the contract.

(4) These rules shall apply both in the case of contracting parties stipulating that the contract shall be deemed rescinded unless performed within the specified time limit, and in the case where performing the contract within the specified time limit is an essential element of contract according to the nature of transaction.

Article 126. Performance within Time Limit as a Non Essential Element of Contract

(1) Should performance of obligation within a specified time limit be not an essential element (term) of contract, the defaulter shall preserve the right to perform his obligation even after the expiration of the time limit, while the first party may request its performance.

(2) Should the first party, however, want to rescind the contract, he shall leave the defaulter an appropriate subsequent time limit for performance.

(3) Should the defaulter fail to perform his obligation within the subsequent time limit, the same consequences shall take place as are otherwise applicable in the case of a time limit being an essential element of contract.

Article 127. Repudiation of Contract without Leaving a Subsequent Time Limit

A party to a contract may repudiate the contract without leaving the defaulter a subsequent time limit for performance, should the defaulter's conduct indicate that he will fail to perform his obligation even in course of subsequent time limit.

Article 128. Repudiation of Contract Prior to Expiration of the Time Limit

Should prior to the expiration of the time limit for performing the obligation it become obvious that one party is not going to meet his contractual obligation, the other party may repudiate the contract and claim damages.

Article 129. Repudiation of Contract with Consecutive Obligations

(1) Should in a contract with consecutive obligations one party fail to perform one obligation, the other party may, in a reasonable time limit, repudiate the contract regarding all future obligations, should existing circumstances obviously indicate that they, too, are not going to be performed.

(2) That party may repudiate the contract not only regarding future obligations, but also regarding obligations already performed should their performance alone be of no interest to him.

(3) The defaulter may preserve the contract after supplying an adequate guarantee.
Article 130. Duty of Notification
A party intending to repudiate the contract due to the defaulter's failure to perform his obligation, shall be bound to notify the defaulter immediately.

Article 131. The Case of Impossible Repudiation
A contract shall not be repudiated due to non-performance (breach) of a minor term.

Article 132. Effect of Repudiation
(1) After a contract is repudiated both parties shall be released from their obligations, except the obligation of compensating for subsequent loss.
(2) A party performing a contract entirely or partially shall be entitled to restitution of that what he has given.
(3) Should both parties be entitled to claim restitution of what has been given, mutual restitution shall be liquidated under the rules of performance of bilateral contracts.
(4) Each party shall owe to the other compensation for benefits enjoyed for the time being from that what he is obliged to restitute, that is to compensate.
(5) A party paying back money shall be obliged to pay interest on arrears from the day of receiving the payment.