Beginner’s Guide for Understanding SME[1] Credit Analysis in FR Yugoslavia

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SUMMARY

This paper will not display any of the standard Corporate Credit Analysis practices and procedures, which can be found in various instruction manuals in the field. However we intend to assist in applying of such principles in order to cope with the reality behind financial reporting of the Serbian body corporate. Our aim is to provide basis for understanding and *restatement of* the local financials in the best possible manner, so as to correspond to both International Accounting Standards (IAS) and reality. Accounting in FR Yugoslavia has in fact several peculiarities to be aware of when analyzing corporate credit, concerning the historic data present in both Balance Sheet and Income Statement. This paper refers to relatively government independent, private, medium size corporations (annual sales DEM 3-10 mio) involved in foreign trade operations.

We will try to inform the reader about *why* the accounts are not transparent, as well as *where* and *when* they are not transparent. We will also try to point out the differences between *importing* and *exporting* companies, and the repercussions of these two determinants of the business on the display of local financial reporting.

The theme is associated to problems of foreign currency in the financials, doing business and accounting in the environment of high disproportion between local and hard currency exchange rates (1996-1999), and the relative consequences on financial reporting and credit analysis. In the end we will provide you with an overview of some common issues and restatements. We intend to convey the message that the sense may be found in it all, and that a meaningful cash flow can be created, for a good number of corporates.

I. INTRODUCTION

Due to adverse economic and political climate present in Serbia throughout the foregone decade, and reaching climax on Oct 5th last year, the economy is in a very poor shape. Business is sprinkled across nonviable, suffering Socially Owned Enterprises (SOE’s), spinning off to dots of new private operations which just now take solid grounds; these are accompanied with a portion of mid-sized businesses which found their way to growth since private business was allowed a decade ago. With the lowered political risk and slow liberalization efforts, foreign capital is gently entering the ‘market’, and domestic SME's will have to grow transparent and consolidate in order to have their growth financed and stay competitive. Externally financed growth, whether supported by raising equity, forming partnerships, *or raising debt*, will ask for a move from the current paranoia into transparency of operations within legal institutions. This is not a short-term task. There is still a very high political risk, slowing down the process of FDI. However all sides are very much aware of the fact that whatever political option is next to come (perhaps stalling the reforms), there is no turning around of the started transition and building of market economy.

One of main enemies for credit market development in Serbia is the currently low quality of financial information and large part of cash settlements, brought about by the environment of mistrust, lack of right incentives, low economic freedoms, weak contracting and discipline enforcement (rule of law).

[1] Small and Medium Enterprises

Traded at Belgrade Stock Exchange are only short NBY T-bills and one-to-three-month commercial notes of the handful of liquid enterprises. EUR 427mio is total 01-08/2001 turnover on BSE. No rating of domestic corporates is produced. Enterprise and industry benchmarking is not possible thus due to lack of institutionalized information and low quality of accounting. It is only possible to compare the two companies if one has access to insider's information.

Audit procedures are obligatory for large enterprises and banks, but are very superficial and promotion- oriented. Very few SME's hired audit agencies during foregone years. In those few cases, opinions of the auditor, although of great value to an analyst, are to be considered more as 'PR' oriented than reliable source of information. Generally, firms have been audited when they wanted to address foreign investor, creditor or a particular supplier. It is broadly believed that auditors simply sold their name against manufatured reports which would portray and enable a company to evade taxes or to avoid highly restrictive regulation for disposing over financial assets.

II. BASIC FEATURES OF A DOMESTIC ENTERPRISE

All successful SMEs present on this market stem from the two extreme models created during the last decade, which we shall refer to as *Shells* and *Politically Correct* ones. Whereas most of firms balanced their business in between these two 'stereotypes', we considered it beneficial to over-simplify and to generalize, in order to introduce the reader to the roots of the problem.

A) ***Shells*** with nothing to steal from: The Downside Case

Shell forerunners are companies whose capital and profits are out of books (cash unrecorded sales), or expropriated onto the own affiliates abroad (out of the country). Similar to their capital, much of the Capital Expenditures (investment in fixed assets) are often not reflected in the balance sheet. Shells will often have their own trading & financing intermediaries outside the country. This model is not to be underestimated, however, as it defines Serbia's present and future SME domestic capital base. These entities, often but recent start-ups, were in the last decade given strong incentives (forced) to seek alternative business channels for doing business, in order to protect their substance and growth. Reasons for such move from legal/domestic institutions to illegal/circumventing business channels, was the *adverse business environment* of:

- High to hyper inflation (or inflatory tax)
- Up to five fold disproportion between the fixed official and floating, illegal market exchange rate
- Scarcity of hard currency in institutions
- Adverse, multi-layer taxation policies and non-tariff barriers
- High government regulation and bureaucracy,
- Low other economic freedoms and
- Frequent property rights violation, often by government itself

For purpose of credit risk assessment, it is important to understand these issues, as they do explain *why* the accounts are untransparent as well as *where* to look for more information. This sort of climate has to the most negative extent resulted in weak financial reporting, basic rudiments of which, from the credit institution's point of view, are

- Low book sales income and nil profits /due to cash sales, and trade intermediation through associates, for profits expatriation and tax evasion/ and thus no book generating ability.
- Low book own funds and hence low book capital adequacy
- High operational leverage, finance on trade credit from own affiliates, untransparent operations

- Lower working investment valuation than actual (stock, inventory, cash), and negative working capital

In many cases this type of corporate will have faultless solvency with satisfactory liquidity, but no investment potential whatsoever : their turnover, accumulated profits, capital and capital investment (fixed assets) will often, partially or fully remain outside of the balance sheet (and sometimes outside of the country).

❖ These entities are not at all happy about the way they do business. However, they will remain doing so to the very same extent, until the stimulating business environment is created for them, in terms of the already stated factors. Some pre-conditions are already met, one being the relative stability of LCY- Dinar, availability of hard FCY, and predictable inflation. However, they will *not* consolidate their hidden (parallel channels) capital and retained earnings before they are able to do it tax-free or with low tax, their private property is guaranteed from violation, iii. they are allowed to freely move their capital and profits, and are given greater economic freedoms and trust in contract.

N.B. Balance Sheet from as of end-2000 generally reveals correct working investment, to the extent that now there are no discrepancies between market and official exchange rates at year-end. Permanent assets and capital will still remain outside for many firms, and trade payables may be unreal, due to the external settlement practice conducted during the period of EU’s white lists. It was allowed to clear them, during the IQ 2001. The 2000 Income Statement, however, is *not accurate* in many ways (see below), and is not to be taken for granted.

B) Politically Correct Corporates

Quite often these are founded as spin-offs, the result of the State Owned Enterprise's (SOE's) value-stripping practice, done by high executives. These have continued to base their strategy on close cooperation with the (former) governing oligarchy, and are therefore deriving various privileges associated with the redistribution of public wealth, such as

- Not paying or paying minuscule taxes, tariffs and contributions (no enforcement)
- Availability of cheap sources of hard currency for imports or just F/X profits
- Monopolistic position over import/export quotas system
- Arbitrary and cheap (public bank) credit, often with interest negative in real terms. Such loans often served as a start-up capital, and were not repaid.

The system created a mafia-like synergy between the business community and the government, resulting in high level of corruption. The line between the two types is of course not very clear and they often merge intensively. Although the latter group has a better starting point considering the initial capital, former are more in number, smaller in size and turnover, more flexible and more innovative, thus having greater competitive potential under an opened economy environment. Both should be targeted, as all companies (even if operated for fifty years) are considered "newborns" under transition, if and once the economy is opened. Until then, the latter will still have great advantage to the former, mainly resulting from the accumulated wealth, good market position and economies of scale.

III. FOREIGN CURRENCY IN THE FINANCIALS, 1996-2000

For the years 1996-1999 (2000 for P&L), there is a significant distortion in all categories containing foreign currency. The difference between official (book) and market (transactions) grew from 1:1 in 1998 (devaluation) to 1:5 near end-2000, when fixed currency was devaluated again. This had an enormous impact on both accounting and business practice. Main difference and point of separation is to be made between importers and exporters, although many firms will combine the two in their regular course of business. We will generalize again, but only to provide with the two new starting points of evaluating a domestic enterprise.

a) Net importers, framework:

Net Importers will have their liabilities (trade payables) undervalued in B/S 1997-1999, showing greater then actual liquidity. Also, for the same respective period, importers will have lower Cost of Goods Sold (COGS) whereas their book Sales (in YUM) will be *a priori* closer to true values, once an average FCY market rate is applied on the figure. They will thus have their gross margins inflated, whereas net operating profits will be brought down by the fictional *charges in the following parts and sub-categories of the Income Statement:*

- ***Operating expenses section*** *of the Income statement (production costs, nonmaterial expense- consultancy services, etc.), or/and*
- ***Financial section*** *(F/X expenses charges, Other financial expense),* or/and
- ***Non-business & Exceptionals*** *(off-writing receivables, and other non-ordinary transactions)*
- ***Revaluation section*** of the Income Statement (later detailed).

These tangible and material expenses should be located and identified if are correlated to cost of obtaining foreign currency on the extensively used black market (usually the difference between the official and market rates was settled between companies), or if the transaction is non-cash and related to biasing net result.

b) Net exporters, framework

On the other hand, net exporters will have, for the same respective period,

- **Undervalued trade receivables** (booked using the official, undervalued rate), perhaps displaying liquidity problems.
- **Undervalued sales income level**, as they were booking sales income (FCY) using the official, lower rate.
- If they completely followed the accounting principles under this high currency disparity situation, exporters would have posted **severe losses at end-2000,** after the five-fold devaluation of dinar near end-2000.

Exporters will have used external advance payment (trade credit) in YUM for export (working capital) finance, whereas trade creditors (importers) will have used their hard currency inflows to settle their creditor claims. Therefore, they will have had their sales income undervalued (expressed by the official rate) and COGS will be real in value, as it is paid in YUM, from the advances received. Once the inflow from the export receivables is collected and the settlement with trade creditors (importers) is effected, there may and may not be extra income (F/X) booked under various categories, depending on if the settlement is done from non-B/S cash or through B/S (for “intellectual” services), or mixed. The exporters have had within this framework an opportunity to balance their Income Statement and show net profit, or net loss, using this mechanism alone.

IV. OTHER COMMON RESTATEMENTS

a) In FR Yugoslavia, Loss is an Asset

Although profits as retained earnings are normally recorded under Capital, losses are not. Losses, under the Yugoslav accounting, are displayed on the assets side as positive. Common practice is to deduct “accumulated losses” against reserves and then against equity.

b) Labor expense is not transparent

It is very difficult to distinguish the total operating expense related to Gross Salary, as this is, under FRY accounting, split in several reporting categories under the Selling, General and Administrative expense (SG&A). Namely, the Gross salary, Non-material expense and Production services expense categories in the Inome statement allow for various employee-related payments and owner withdrawals to be recorded throughout this part of the P&L, thus making it non-transparent. It is sometimes crucial for a labour intensive business to identify and separate labor from the other operating costs so as to correctly assess the partake in costs.

c) “Revaluation” Issue

A “revaluation” part of the Income statement comes after SG&A, Financials, Non-business and exceptional, and before taxes. These, revaluation income and expense are meant to be separated from the rest of the Income statement categories, so as to leave these material categories free from revaluation impact on their value (non-cash), and thus make the statements more *transparent* in the environment of high inflation. This “noble” cause was in practice twisted terribly, as “revaluation” became everybody’s place of manipulation with the final, pre-tax Income figure.

There are many businesses, which respectfully apply the accounting principles in this field. So we will present the basics of how to interpret this part of the Income statement, which is important to construct a meaningful cash flow table. Generally speaking, guidelines to keep in mind are:

- Positive revaluation of Assets is a Revaluation Income, while positive revaluation of Liabilities and Equity is Revaluation Expense. There is no negative revaluation.
- Fixed Assets and local currency Equity capital are revalued using the CPI growth indice, more or less, while all Foreign Currency (FCY)- valued balance sheet categories are revalued according to the *official* exchange rate fluctuation.

In terms of that, at end-2000, when Dinar was devaluated five-fold, those with excess FCY liabilities and Equity would generally have recorded diminishing losses and a drop in liquidity (importers), while those with excess FCY assets (exporters) would have recorded enormous profits and liquidity rise.
Of course this is said only to alert to the fact that one must take into careful consideration all the aspects and implications of the issue of revaluation in the Income statement, and their effect on cashflows.

In restatement to IAS, we have an impact on all B/S, I/S, and the cash-flow statement.

- **Income statement**: revaluation of foreign currency receivables, payables etcetera should be restated as unrealized foreign exchange (F/X) gain or loss in the financial section, whereas Revaluation of Fixed Assets and Equity should be completely excluded from net result.
- **Balance sheet**: Base equity should be restated to separate revaluation effect, and total accumulated, inflation-oriented Fixed Assets revaluation should be is reflected under single equity category as a monetary gain, or accounting change (non-cash).
- **Cashflows**: Already restated unrealized F/X gains/losses based on revaluation of receivables and payables must be recorded under change of same relative categories in the pre-Net Operating Cash Flow, part of cashflow statement, as to exclude the non-cash transactions from Change in Working Investment. Financial result is free of non-cash revaluation impact here.

V. CLOSING REMARKS

These were just the general points of clarification of what falls under doing credit analysis and company valuation in FR Yugoslavia. However, we would like to stress that the context is often all but clear and cohesive, and the credit analyst must be a valuation consultant as well. Yugoslav accounting practice not only differs from IAS (especially from IAS-29), but the rules are loose and financial discipline is not well enforced. Domestic reporting will not provide the analyst with “data comparable over the course of time” unless serious efforts are put in audit and restatement. Historic results are not a good benchmark and the cashflow approach is widely suggested when analyzing corporate credit. Financial reporting, though of utmost importance, should be normally used only as a signal light for where to look further. It should be complemented with carefully crafted questionnaires and personal contact with the Co’s management, in order to obtain qualitative information.
The State develops restrictive regulation in order to control the economy, and to prevent an outflow of capital. A decrease to the State’s interventionism, fighting corruption, gray economy and rent-seeking, along with an increase to economic freedom, are the only route to creating a better business environment.
At the moment, creditor’s short-term task on the Serbian market is to reckognise potential, with strong accent on management and business strategy evaluation. Bank needs to invest in relationship with such corporates.