

The Impact of SME Financing Policies on Financial Reporting: A Case Study

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Abstract: Considering financing crucial for the daily survival of entities, it is fundamental to understand the impact of the measures taken by companies regarding the financing obtained. Therefore, the study aims to analyse the impact of financing policies on the financial reporting of entities through an analysis of the financial statements for the year 2021 of three entities. After analysing the results, it is demonstrated that bank loans are the main source of financing used by entities to fund their investments. However, it is noted that the entities under analysis seek external sources of financing, which has significantly increased their financial dependence. Therefore, when compared to their industry sector, these entities have a much lower level of financing via Equity. Regarding the financing costs incurred by their financing policies, it is observed that these are significantly high, mainly in relation to the weight of financing costs in total EBITDA, which impacts the net result of the period. Finally, the high impact of the rise in the Euribor rate on financing costs in 2023 was demonstrated. Thus, it is evident that in relation to other sources of financing, their respective expenses will increase dramatically, potentially greatly affecting the results of the companies.

Keywords: Financing Policies, SMEs, Euribor Rate, Financial Reporting, Funding Difficulties, Bank Loan

1. Introduction

SMEs are the main driver of the European economy, crucial for enhancing competitiveness and employment. They make up 99% of businesses in Europe (European Commission, 2003) and generate 56.4% of the wealth (Muller et al., 2019). In Portugal, SMEs represent 99.9% of businesses, with 1,333,649 SMEs, 96% being micro-enterprises. They employ 77.37% of the workforce and, in 2021, generated 60.46% of the country's wealth.

Small business owners are pillars of society and need support for sustainable growth. Financing is key for their stability, allowing business expansion and meeting short-term obligations (Barbosa & Pinho, 2016). Companies should be aware of diverse financing methods to suit their needs (Tavares et al., 2015).

SMEs face more financial constraints than larger firms, hindering their access to funding and growth (Beck & Demirguc-Kunt, 2006). Early-stage SMEs struggle with a lack of commercial history and high risk of failure, affecting financing conditions and trust from financial institutions. The type of financing chosen can significantly impact financial reporting, affecting balance sheets and income statements, and influencing financial ratios and market equilibrium.

Bank loans, the primary financing source (Ferreira, 2020), involve higher interest costs and debt amortization, often linked to the Euribor rate. Early-stage SMEs face higher financing costs due to higher risk spreads. Higher risk also leads to shorter loan periods, increasing repayment amounts.

This study aims to analyse the impact of financing policies on SMEs' financial reporting. The goal is to highlight the significant effects financial crises can have on companies' results through increased interest rates combating inflation.

After this introduction, this paper is structured as follows: the next section presents a background on the topic; section 3 presents the methodology adopted to collect and process the data and the definition and characterisation of the sample; section 4 is dedicated to the presentation and discussion of the results and, finally, the main conclusions, limitations of the study and suggestions for future research are presented.

2. Background

The relationship between companies and banks is intricate and often disadvantages smaller firms (Correia, 2018). Smaller companies face challenges in securing favorable financing terms due to their size and market position. Established companies typically benefit from better financing conditions, such as lower interest rates and larger loans, due to their stability and lower risk profile (Neves, 2009). In contrast, larger banks prefer to finance well-established companies over smaller ones.

Smaller companies often struggle with poorer financial information and fewer assets (Rostamkalaei & Freel, 2016). High information costs for these firms result in less favorable financing terms, with interest rates reflecting both the opportunity cost of internal funds and an additional risk premium (Farinha, 1999). This results in higher financing costs and limited liquidity.

In Portugal, competition among banks, including foreign banks, might offer smaller companies alternative financing options like factoring and leasing (Beck et al., 2010). However, micro-enterprises often face high risks and lack of information, which can prevent this competition from reducing interest rates (Ferreira, 2020). Comprehensive financial information is essential for banks to assess risks and offer better credit conditions.

The European Central Bank's survey indicates that SMEs encounter obstacles such as loan rejections and high costs (Bankowska et al., 2020). In Portugal, common difficulties include high interest rates, stringent guarantees, bureaucratic processes, and long credit approval times (Lopes, 2014). Interest rates, collateral requirements, and the availability of relevant information are key barriers. SMEs, viewed as high-risk due to insufficient assets and market vulnerability, face higher interest rates to mitigate these risks (Bădulescu, 2010). They also struggle with recruiting qualified staff and adapting to market changes.

The opacity of SMEs and their lack of audited financial statements further complicate financing (Beck, 2008). In contrast, larger firms can provide substantial guarantees and are better able to meet short-term financial commitments. Banks view SMEs as high credit risks in a competitive environment and are reluctant to approve loans without positive cash flows, regardless of collateral (Jovin, 2016).

Information asymmetry arises from the absence of audited financial statements, limiting banks' ability to assess companies' credibility and risk (Bădulescu, 2010). Larger companies offer more detailed information about their operations and strategies, which helps banks evaluate performance and risk more effectively (Miller, 2003). Smaller firms often withhold critical success factors, making it harder for banks to trust and assess them.

Lopes (2014) examined how SMEs in Portugal secure financing and the main constraints they face through a questionnaire of 31 SMEs recognized in 2013. The study found that SMEs are heavily reliant on bank financing, facing significant challenges with high interest rates and stringent collateral requirements. The study also highlighted the growing importance of financial statements in building trust between banks and SMEs.

Correia (2018) explored financing difficulties for Portuguese SMEs using an econometric model from 2006 to 2015. The study found that business volume is crucial for accessing financing, with collateral requirements being a major barrier, especially for new companies with medium- and long-term investment needs.

Luzio (2015) investigated factors influencing bank financing for Portuguese SMEs using a sample of 2,689 companies from 2010 to 2013. The analysis showed that larger companies find it easier to access bank financing, and credit availability increases with export activities. Consistent with other research, collateral remains a key factor, with larger assets facilitating financing access.

Internationally, Masiak et al. (2019) compared financing between SMEs and large enterprises. Their study of 2,144 SMEs across 27 European countries found that small businesses face challenges due to high costs and information asymmetries. Microenterprises particularly rely on bank loans to address financing needs.

Kumar and Rao (2016) provided insights into common financing policies among SMEs through a study of 1,524 Indian SMEs from 2006 to 2013. Their findings revealed that trade credit and bank loans are the most used financing sources, with company age, profitability, tangible assets, and liquidity being critical for securing financing.

3. Methodology and Sample

This case study will analyze the financing issues of three entities from a small accounting firm's client portfolio. It aims to evaluate how financing policies affect financial statements and ratios. The study will compare these costs with industry benchmarks.

An exploratory case study methodology will be used, involving data collection through document analysis. This will include management reports and financial statements for 2021 to assess financing policies and their effects on financial reporting. The analysis will focus on the entities' financial statements and relevant indicators and ratios.

To comply with Law No. 58/2019 of August 8, regarding the Data Protection Regime, the identification of the entities under study will not be disclosed. The entities will be referred to as entities A, B, and C.

Subsequently, through Table 1, relevant data for the study about entities A, B, and C for the year 2021 will be presented.

Table 1: Data on the entities analysed in 2021

	A	B	C
Sector of activity	Sock production	Organising transport	Trade and Distribution of Food Products
Year of foundation	1995	2013	1999
Number of employees	56	13	20
Turnover	4 977 425,16€	2 705 670€	3 543 543,62€
Assets	5 421 250,50€	1 643 188,04€	1 925 670,88€
Liabilities	4 226 342,43€	1 502 093,64€	1 560 766,41€
Equity	1 194 908,07€	141 094,40€	364 904,47€
Net profit	616 761,64€	40 660,37€	25 644,42€
No. of banks they work with	7	4	3
Applicable accounting standards	General accounting standards	Standard for small entities	Standard for small entities

Based on Table 1, the analysed companies are from completely different sectors with extensive market experience. Company A has the highest turnover but also significantly higher liabilities. Despite good results in 2021, all companies have a high debt-to-asset ratio, which could lead to future financial autonomy issues.

Company A follows the general system of the 28 Accounting and Financial Reporting Standards of the Accounting Standardization System in Portugal, while companies B and C follow the small entities' standards.

According to Decree-Law No. 372/2007 of November 6, all companies are classified as small entities, as they exceed the limits for micro-entities. However, while company A exceeds the worker limit (56 workers in 2021), its turnover and balance sheet value are below the medium-sized entity limit. Companies B and C have 13 and 20 workers, respectively.

Finally, company A operates with 7 banks, unlike companies B and C, which work with 4 and 3 banks, respectively.

3.1 Analysis and Discussion of Results

3.1.1 Analysis of Financing Policies and Their Impact on Financial Statements and Financing Ratios

To begin analysing the financing policies of the respective entities, it is essential to understand their balance sheet structure and compare it with the sector they belong to.

The Balance Sheet is a document that reflects an entity's financial situation at a specific period. Based on Table 2, we can compare the balance sheet structures of the entities in this study. A Balance Sheet must comply with the Minimum Financial Equilibrium Rule (MFER), meaning Current Assets should be equal to or greater than Current Liabilities, and the company's Permanent Capital should exceed Non-Current Assets (Fernandes et al., 2019). In practice, entities must allow their investments to turn into cash to meet their debts and financial obligations.

Table 2: Balance Sheet Structure of Entities A, B and C in 2021

	A	B	C
Assets	5 421 250,50€	1 643 188,04€	1 925 670,88€
Non-current assets	2 737 260,52€	542 359,00€	722 200,01€
Current assets	2 683 989,98€	1 100 829,04€	1 203 470,87€
Equity	1 194 908,07€	141 094,4€	364 904,47€
Liabilities	4 226 342,43€	1 502 093,64€	1 560 766,41€
Non-current liabilities	1 622 112,04€	340 851,76€	369 032,83€
Current liabilities	2 604 230,39€	1 161 241,88€	1 191 733,58€

Based on the analysis from Table 2, Entity B has a short-term financial imbalance, with Current Assets being lower than Current Liabilities. This means its investments take longer to convert into cash to meet short-term obligations. Entities A and C have Current Assets close to Current Liabilities, which, despite being slightly higher, may cause cash flow issues if there are production problems or customer loss.

To analyse the impact of financing policies, it's important to examine the liability structure and identify their effects on financial statements. Additionally, financial and economic ratios should be analysed to draw conclusions about the adopted financing policies. A comparative analysis with the sector in which these entities operate will also be conducted.

This analysis will be illustrated in the following tables.

Table 3: Liability Structure of Entities A, B and C in 2021

	A	B	C
Non-current liabilities	1 622 112,04€	340 851,76€	369 032,83€
M/L term financing	1 622 112,04€	340 851,76€	369 032,83€
Current liabilities	2 604 230,39€	1 161 241,88€	1 191 733,58€
Suppliers	1 285 346,11€	703 442,96€	681 504,88€
State and other public entities	60 484,02€	52 274,10€	38 418,97€
Short term loans	944 613,05€	169 858,77€	344 105,58€
Other debts payable	313 787,21€	0€	0€
Deferrals	0€	0€	0€
Other current liabilities	0€	235 666,05€	127 704,15€
Liabilities	4 226 342,43€	1 502 093,64€	1 560 766,41€
Weight of financing in total liabilities	60,73%	33,99%	45,69%
Weight of short-term financing in current liabilities	36,27%	14,63%	28,87%

After analysing Table 3, it is evident that financing represents a significant portion of the total liabilities for Entities A, B, and C, especially for Entity A, where 60.73% of its liabilities are composed of financing. Additionally, 36.27% of Entity A's Current Liabilities are short-term loans that must be repaid within a year.

Entities B and C also have a notable portion of their liabilities in financing. For Entity B, only 14.63% of the financing is short-term. In contrast, almost half of Entity C's liabilities are financed, with 28.87% being short-term loans.

Next, the sources of financing for these entities will be compared with their industry sector.

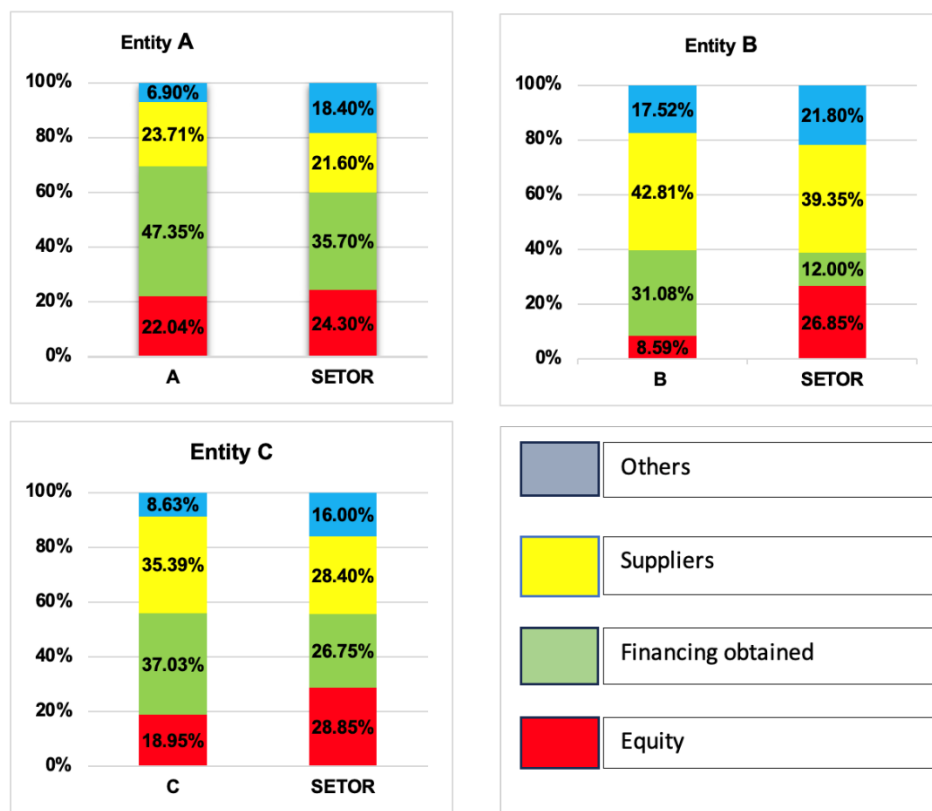


Figure 1: Comparison of Financing Sources in 2021 (% of assets)

Source: Sector data retrieved from Banco de Portugal

Through figure 1, it's possible to compare the funding sources' weight on total assets with the sector of activity to which the respective entities belong, as stipulated by Banco de Portugal. It's noticeable that the entities under study have a lower equity financing compared to their respective sector, notably Entity B, which only has 8.59% equity financing compared to 26.85% in its sector. This demonstrates a high dependence on external funding for potential investments, thereby increasing financial dependency.

Similarly, there's a significantly higher proportion of bank loans in their financing structure compared to the sector, particularly in Entity A, where bank loans represent 47.35% of total assets, compared to 35.70% in its sector. This category implies additional efforts to meet obligations to banks, including payment of associated interest and fees. Additionally, there's a higher weight of commitments to suppliers compared to their respective sectors.

Based on this analysis, conclusions can be drawn regarding the entities' higher dependency on their sectors and the considerably higher proportion of obtained financing. This demonstrates that the financing policies adopted by these entities heavily impact their liabilities, necessitating consideration of the costs incurred through these financing policies.

Next, the weight of these types of financing in total liabilities will be analysed.

Table 4: Weight of Financing Sources in Total Liabilities in 2021

	A	% of liabilities	B	% of liabilities	C	% of liabilities
Bank loans	2 371 404,06€	56,11%	501 225,24€	33,37%	708 487,05€	45,39%
Bank loan to support COVID-19	343 518,52€	8,13%	50 000,00€	3,33%	450 000,00€	28,83%
Bank loan (fixed asset financing)	31 944,95€	0,76%	-----	0%	-----	0%
Bank loans to boost growth	150 000,00€	3,55%	35 000,00€	2,33%	2 360,335	0,15%
Confirming	-----	0%	-----	0%	39 273,22€	2,52%
Finance Leases	195 321,03€	4,62%	9 485,29€	0,63%	4 651,36€	0,30%

Thus, based on the analysis of table 4 regarding the weight of financing types in the total liabilities of the entities under study, a significant emphasis is placed on bank loans. At first glance, bank loans represent 56.11% of Entity A's liabilities, 33.37% of Entity B's liabilities, and 45.39% of Entity C's liabilities, respectively.

Next, in figure 2, the weight of bank loans in total financing obtained will be analysed compared to the sector of activity.

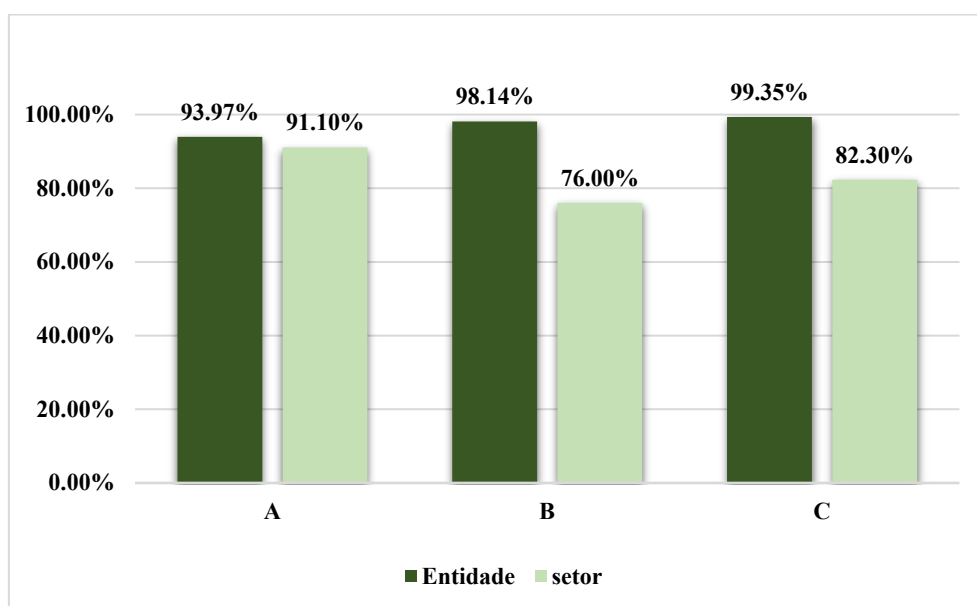


Figure 2: Weight of bank loans in total borrowings in 2021

In comparison to their respective sectors of activity, the entities under study show a significantly higher proportion of bank loans as part of their total financing obtained. Specifically, Entity B has 98.14% of its total

financing obtained from bank loans, compared to 76% in its sector. Similarly, Entity C has 99.35% from bank loans, compared to 82.30% in its sector. These figures indicate a greater financial dependency on bank loans to fund essential activities necessary for the entities' operations.

Table 5: Indicators of the entities' sources of funding in 2021

	A	B	C
Finance obtained	2 566 725,09€	510 710,53€	713 138,41€
Financing costs	85 724,39€	26 014,39€	16 161,40€
<i>Bank commissions</i>	<i>19 933,90€</i>	<i>8 820,10€</i>	<i>1 201,99€</i>
<i>Supported Interest</i>	<i>65 790,49€</i>	<i>17 194,29€</i>	<i>14 959,41€</i>
EBITDA	1.130.974,59€	88.027,13€	63.151,13€
Cost of loans obtained	3,34%	5,09%	2,27%
Coverage of financing costs	13,19	3,38	3,91
Weight of financing obtained in EBITDA	2,27	5,80	11,29

Weight of financing obtained in EBITDA is intended to give an indication of the number of years needed for the EBITDA generated during the period to be sufficient to cover the financing obtained, assuming that the levels of both indicators are maintained. It is calculated as the ratio between Borrowings / EBITDA.

Source: Banco de Portugal

Analysing the inherent costs of the financing policies adopted by the entities in 2021 (table 5), several notable points emerge. Firstly, Entity A bears substantial financing costs amounting to €85,724.39, in contrast to Entities B and C, which bear €26,014.39 and €16,161.40 respectively. These financing costs are related to bank loans and respective financial leases. Particularly significant are the high bank commissions accrued by banks due to these financing policies, with Entity A facing approximately €19,933.90 in such charges.

Examining further indicators regarding the financing sources of the entities under analysis, it becomes evident that the financing costs differ significantly among them. Entity B, despite having the lowest amount under the financing obtained category, incurs the highest percentage of financing costs at 5.09%. Additionally, it is noteworthy that Entity B's EBITDA is only 3.38 times higher than its financing costs, whereas Entity A boasts an EBITDA that is 13.19 times greater than its financing costs, highlighting its effective management and operational efficiency in the market.

Regarding the proportion of financing obtained relative to total EBITDA, it can be concluded that on average, Entity A would need approximately 2.27 years for its EBITDA generated during the period to cover its financing obtained, assuming both remain constant. In contrast, Entity C would require over 11 years for its generated EBITDA to be sufficient to cover its financing obtained. This indicates that Entity C faces substantial costs throughout the year compared to the income generated.

These insights underscore the varying financial dynamics and management efficiencies across the entities studied, reflecting their strategies and operational strengths in managing financing challenges.

Table 6: Comparison of funding source indicators in 2021 with those of the respective sectors of activity

	A	Sector	B	Sector	C	Sector
Cost of loans obtained	3,34%	2,20%	5,09%	3,50%	2,27%	1,40%
Coverage of financing costs	13,19	6	3,38	20,1	3,91	19,5
Weight of financing obtained in EBITDA	2,27	7,7	5,8	1,4	11,29	3,8

Comparing to the sector of activity (table 6), regarding the costs of financing obtained, we observe that the entities under analysis have a higher proportion than their respective sectors, with the largest percentage difference in Entity B, which has 5.09% compared to 3.50% in the sector, despite having the lowest amount of financing obtained among the entities.

Looking at the coverage of EBITDA over financing costs, Entity A shows a very positive result compared to its sector, with EBITDA covering its financing costs 13.19 times, whereas the sector's average is covered 6 times. In contrast, Entities B and C exhibit weaker performance in 2021 compared to their sectors. Entity B's EBITDA covers its financing costs 3.38 times, compared to 20.1 times in the sector, indicating a lower ability to cover expenses with generated income. Similarly, Entity C's EBITDA covers its financing costs 3.91 times, compared to 19.5 times in the sector, further illustrating a lower financial efficiency relative to the sector.

These comparisons highlight the financial dynamics where Entity A demonstrates robust financial management relative to its sector, while Entities B and C face greater challenges in managing their financing costs compared to their sector benchmarks.

These results show the significant impact that bank loan costs can have on company management, especially if there are significant increases in reference interest rates, as we have seen recently. Companies could face high risks of cash flow difficulties

3.1.2 Analysis of Financial and Economic Ratios

In order to analyse each company in detail, we chose to calculate several ratios, as per table 7.

Table 7: Financial and economic ratios

Ratio	A	B	C
Coverage of fixed assets	1,03	0,89	1,02
Liquidity	1,03	0,95	1,01
Financial Autonomy	0,22	0,09	0,19
Indebtedness	0,78	0,91	0,81
Return on Equity	0,52	0,29	0,07
Return on Sales	0,12	0,02	0,01
Average term of receipts	65	93	66
Average term of payments	105	95	64

Therefore, according to table 7, we can observe that in terms of the Fixed Assets Coverage ratio, Entity B records a value below 1, meaning its permanent capital is insufficient to finance its non-current assets. This implies that the entity is financing medium to long-term assets with obligations that need to be paid within 12 months. This situation could lead to liquidity problems, as indicated by the Liquidity ratio, where its current liabilities exceed its current assets. These results indicate that the entity may struggle to meet its short-term obligations due to insufficient financial resources.

Thus, Entity B clearly fails to meet the Minimum Financial Balance Rule. Although Entities A and C have Fixed Assets Coverage and Liquidity ratios above 1, their liquidity is still weak. They may struggle with short-term commitments if working capital issues arise, given the limited buffer for potential problems like delayed customer payments or production issues.

The Equity Ratio for the entities is below the 33% benchmark, indicating insufficient equity to finance their investments. Entity B funds only 8% of its investments with equity, while Entities A and C use 22% and 19%, respectively. This low equity corresponds to high debt ratios, with Entity B's debt ratio at 91%. Additionally, Entities A and B have high liability proportions relative to total assets, at 78% and 81%, respectively.

Moving to the analysis through economic indicators, we observe that Entity C has a very low Return on Equity (ROE). This indicates that for every euro invested in the entity, shareholders receive a return of only 7 cents. In contrast, Entity A has an excellent ROE ratio, as for every euro invested in the company, there is a return of 52 cents.

Regarding Return on Sales (ROS), similarly, Entity C shows a low return, where for every euro the entity sells, there is only 1 cent in profit. The same applies to Entity B, which has a return of 2 cents for every 1€ sold. Entity A, however, demonstrates a relatively better ROS ratio compared to the other entities, achieving a profit of 12 cents for every euro sold.

Finally, concerning the average collection and payment periods, we notice excellent management by Entity A in these areas. On average, it collects from its customers in 65 days, while its payments to supplier's average 105 days. Entities B and C have very similar average collection and payment periods, with Entity C paying its suppliers earlier compared to its average customer collection days, 66 and 64 days respectively.

4. Conclusions, Limitations, and Suggestions for Future Research

Based on the analysis of the financing policies of Entities A, B, and C and their respective impact on their financial reporting, we can conclude that bank loans are the primary source of financing used by these entities to fund their investments, as highlighted by Lopes (2014), Ferreira (2020), Tavares et al. (2015), and Kumar and Rao (2016). Additionally, it has been shown that the entities adopt other types of financing such as Confirming policies, financial leasing contracts, and supplementary payments, as demonstrated by Tavares et al. (2015).

All these sources of financing indicate that the entities are financially dependent, as their financing via equity is very low, which translates into a relatively low level of self-financing compared to common benchmarks, as concluded by Masiak et al. (2019). Consequently, the level of indebtedness is high, requiring these companies to maintain good treasury management to meet their commitments, especially with regard to the financing obtained. Therefore, when comparing the structure of financing sources, we conclude that the entities have a much lower level of equity financing compared to their industry sector.

Furthermore, it is evident that the entities fall below average in some analysed indicators, particularly in financing costs, which are significantly high, and especially in terms of the proportion of financing costs to total EBITDA. This leads to the conclusion that a substantial portion of the company's earnings will be deducted due to financing costs.

Regarding the analysis of financial and economic ratios, Entity A is found to be the most financially balanced, despite some indicators not meeting reference values, especially concerning financial autonomy. In contrast, Entities B and C fall significantly short of reference values, indicating some financial imbalance, particularly in terms of financial autonomy and fixed assets coverage. This is reflected in the financing of medium to long-term assets with short-term debts, thus not complying with the Minimum Financial Balance Rule (REFM). Additionally, there seems to be some operational inefficiency in Entities B and C, as evidenced by their low Return on Sales ratios, where these entities achieve a return of only 2 cents (Entity B) and 1 cent (Entity C) for every euro sold, respectively.

This case study helps to understand the impact that using sources of finance that are highly dependent on bank loans can have on the financial position of companies. It helps to understand the impact on the companies' balance sheet structure, the costs related to these loans and the economic and financial ratios.

Therefore, while financing through bank loans can be an effective strategy for accessing capital and maintaining shareholder control, it is essential that companies carefully balance their capital structure and consider the risks associated with high leverage. Prudent debt management and constant analysis of repayment capacity are key to mitigating potential negative impacts.

As limitations of our study, we can point out that the research focused on only 3 entities. Therefore, for future research, we propose expanding the study to a sample of entities representative of the Portuguese business landscape. Furthermore, this report was based on financial data from the year 2021, as financial statements for 2022 were not available at the time of the report's preparation.

Acknowledgment

This work is financed by national funds through the FCT - Foundation for Science and Technology, I.P., under project UIDB/04043/2020.

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