Journal of Business and Economics, ISSN 2155-7950, USA
December 2022, Volume 13, No. 12, pp. 634-639
Doi: 10.15341/jbe(2155-7950)/12.13.2022/002

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Target Capital Structure and Financial Risk in Family Firms

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Abstracts: Family businesses build up a large proportion of businesses in Poland and also all around the world. Family businesses are considered to be a special type of business entities. They have unique characteristics that may represent one side of their competitive advantage and, secondly, that exhibit a factor harmful to their development. This is mainly due to the role of the owner and his family in the process of business management. Characteristics of family businesses in various stages of development are the strength and the source of their success or weakness and cause failure.

Modelling the target capital structure in family businesses is related to the risk of financing sources. The risk of a source of financing is the probability of a company losing its ability to service its debt as a result of the adverse impact of the environment. This paper describes the identification, measurement and risk management of sources of funding in family businesses. Constant changes in the markets in particular financial force the enterprise to formulate its own risk policy concept and thus develop a logical set of behaviors that take the form of a decision-making process, called the risk management process. The paper presents the author's methodology of risk management in family businesses.

Key words: capital structure, debt ratio, financial risk, financing
JEL codes: G

1. Introduction

Risk identification involves the analysis of multiple levels of business activity and its relationships with the environment. This analysis should consist in gathering information about the company, the scope and purpose of its activities and its possible sources of risk. Focus should be placed on the circumstances that may affect the achievement of company's goals.

We should take into account all direct and indirect causes that could cause damage to the business assets in the future (understood not only as material goods but also as a number of other factors such as employees, customers, brands, contractors, know-how). Risk does not only mean a threat but also an unrealized, lost benefit (Jajuga K., p. 13).

The risk analysis should cover both intra-company processes, as well as external processes, with particular emphasis on factors that have a direct and indirect impact on the entity's operations, i.e., finance, organizational and managerial processes, the IT environment and the areas specific to the particular type of business (Kumpiałowska

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A., p. 48).

An individual area is the type of business. External risk identification should include: economic environment, legal environment, contractors, customers, competition and infrastructure (Kumpiałowska A., p. 54). Research shows that Polish businessmen most frequently use management level discussion and managerial experience as a method of risk identification. Increasingly, risk registries are deployed, and services of specialist advisers are used (Słobosz J., Ziomko R., Przywecki M., pp. 24, 32).

Risk identification should be a systematic, and not a one-off, process. Two phases can be distinguished here. For companies or business areas that identify risk for the first time, we can talk about an initial risk identification. On the other hand, for organizations that have already implemented the risk management process, we can talk about a continuous phase of risk identification, where, in the context of a risk management process, identification focuses on monitoring the occurrence of new risks and verifying accepted assessments of previously identified risks (Kumpiałowska A., p. 53). The risk groups to which Polish entrepreneurs declare good preparation are primarily financial risks.

2. Identification of Financial Risk Areas in a Family Business

A special group of companies in Poland are family businesses. Financial risk depends here on many aspects, e.g., how long has the company been operating, what is its life cycle, what is its line of business, what is its legal form and ownership. The development of a family business is usually multidimensional and covers the size of the enterprise, family and property. Family members may have some common economic goals, while their other goals might be different. Managing the family business financing structure is primarily a matter of balancing the financial target and the non-financial predominant investor family. Family members exert a significant influence on the family business or they manage it directly. They feel responsible for the day-to-day operation and development prospects of a family business. They are characterized by their loyalty and personal commitment and the conviction that they should maintain the family character of the company and the obligation to hand it over to the next generations. Entrepreneurial independence consists in combining owner and manager functions. Personal involvement in the business activities is associated with the acquisition of most risks. Research conducted by M. Lyagoubeo (2003) has shown that family businesses have a higher share of fixed assets and growth dynamics, lower revenue growth rates, are more profitable and benefit from lower leverage. Family businesses are reluctant to acquire external financing for fear of diluting ownership and control. Focused family businesses are more prone to consumption, but at the same time are less likely to take risks and are characterized by higher debt ratios (Schulze W. S. & Lubatkin M. H. L., 2001). The increase in the number of owners in a family business can cause a shift of risk. Group members tend to make more risky decisions. Moving your business to the stage of a scattered family business can mean a reduction in your company's debt level.

The succession of power and ownership (a type of legal form), the professionalism of management, and the ability to overcome the negative impact of family conflicts are immensely important to the business. Companies that operate on the basis of an entry into the business activity register or a two-person personal partnership do not have the opportunity to go through critical moments connected with the departure or illness of their founder. If the process of transferring a family business to the next generation is to take place without disruption for the company and its environment, it is advisable to change the legal form of business to a commercial partnership. For legal reasons, in the event of death or illness of the owner, a company operating on the basis of an entry in tote business activity register is unable to continue its business activity. Banks, leasing companies and public institutions denounce the contracts and demand immediate repayment of debt or grants. Employees of the company should be paid for the notice period. An important step is a professionally prepared financial plan that takes into account the legal and fiscal situation and its impact on the financial needs of the family and business. The increase in the number of owners in a family business can cause a shift in risk. Group members tend to make more risky decisions. Moving the business to the stage of a scattered family business can mean a reduction in the company's debt level. Representatives of the younger generation have a higher risk and debt tolerance than older generations.

3. Target Capital Structure for Family Businesses

Literature defines family businesses as units of any legal form in which the capital is fully or partly owned by the family. One or several family members have a decisive influence on the management, or they might hold a managerial position to maintain the particular part of the company in family's hands (Safin K., 2007, p. 42). Ł. Sułkowski provides a different definition — a family business is an economic entity in which the majority of the ownership structure and management function of that entity remain in the hands of one family (Sułkowski Ł., n.d.).

A family business must operate for a long period of time and maintain successive generations; additionally, a secure and responsible financial economy is required. Each company owns fixed assets and working capital, which is necessary to operate. Expenditures can be financed from two sources-equity or foreign capital. Equity comes from the company itself or from the shareholders. They are the financial surpluses generated from the business or from the shareholders. Foreign capital is extracted from the outside - from the environment in which the company operates.

Owners of family businesses are characterized by a marked reluctance to use external sources of capital. Most family business owners use their own means, i.e., retained earnings, depreciation, shareholder contributions, venture capital or public equity issues. Family businesses prefer the least risky and easiest sources of financing. First they use the retained earnings and equity instruments, and then, debt instruments. Funding by means of high risk funds, including business angels, is in Poland in at the stage of development. Family businesses also benefit from external equity financing. The market offers a wide range of bank loans, credit cards and bills. Working capital loans are used to finance the company's current operations and investment loans finance the implementation of long-term investment projects.

The condition for granting credit is that the company has a creditworthiness, understood as the ability to repay the loan, along with the interest, at contractual terms. The assessment of the creditworthiness of an enterprise does not apply only to its current situation but, above all, to its forecasted results. The role of the relationship with the funding institution in a family business can be analyzed in different stages of the enterprise. While in periods of economic downturn, assuming a stable financial position of the entity and low financial needs, this relationship is of less economic importance, in the circumstances of financial crisis it may have a key impact on the survival of the company. Analysis of the impact of financial relationships on the functioning of a company should take into account not only the objective condition of the economy and the company, but also the implications of the theory of imperfect contracts (financing under uncertainty) (Stradomski M., 2010).

An attractive form of financing are loans designed to create jobs in the business. An increasingly popular source of financing is leasing, which is also used by family businesses. It is particularly attractive for startup companies, as it does not require that they have a sufficiently long service life and collateral that would be required when applying for a bank loan. Another form of financing is franchising. The role of grants and subsidies, particularly those coming from the European Union, is also growing. Merchants credit is also of no little importance.

The third way to finance the development of family businesses is equity financing. This type of capital can be obtained from investors or from natural or legal persons in exchange for a specific share in the company's ownership, with the result of them becoming an economic partner and gaining the right to control and influence the management of the company and access to information previously treated as confidential. For family businesses with a high degree of ownership concentration, equity financing, which involves the need for new external shareholders, seems to be controversial from the family's point of view, but often the only one that guarantees raising capital for growth and, at the same time, achieving liquidity that allows for a smooth withdrawal from a family venture. Family shareholders are competing with the company for liquidity and capital controls. Having control is related to deciding how to use liquid cash flow. They can be treated as liquid funds for shareholders who may wish to make a portion of their family assets for purposes other than those of a family business, or as capital to be reinvested in a joint venture. In multi-generational corporations, non-affiliated stakeholders can be the majority in the company and therefore have more control over the minority shareholders. The time it takes to declare sales of shares by some family members and the availability of the cash necessary to fund these transactions can be important factors for the company to continue operating. If a company cannot afford to pay cash to buy back shares, the only solution to the claims issue is to sell the company or make it available to outside investors.

From a business family's point of view, equity financing has several important advantages: it does not burden the company's financial performance with the obligation to pay its debts (as opposed to raising funds by taking credits and loans), the interests of family business owners and external investors are convergent. Equity investors are more concerned with the growth and expansion of the business than the financial lending institutions, whose focus is primarily on obtaining adequate collateral. A capital investor is not only the source of financial resources required for making a profit, but also a valuable source of information, fresh ideas, concepts and new contacts beneficial for the company. For family businesses that are most likely to have a strong, fairly closed organizational culture, this may be an additional growth factor. Withdrawal from credit obligations in favor of equity financing increases the company's overall creditworthiness and enables wider access to credit in the future.

Equity financing in the case of family businesses is, however, subject to certain material disadvantages: equity investors are more exposed to risk than credit institutions because, in the event of failure, the lenders claim first and then the owners. In return for higher financial returns, which might mean higher capital financing costs, equity financing for closed-end family businesses is complex. To be on the capital market, a company must meet certain procedural requirements or launch investor search mechanisms, the price for being able to raise funds for development is most often the restriction of the family business's independence to capital donors. The most popular forms of equity financing for family businesses in the developed market economy include: market entry with public offering, private equity trading, speculative capital and strategic partnership (Popczyk W., 2010).

4. Methodology of Risk Management of Sources of Financing Family Businesses

Risk management is not about avoiding risk; Instead, it means using the best skills to estimate the amount of risk and ensure adequate income (Riehl H., 2001, p. 24). The risk of a source of financing is the likelihood of a company losing its ability to service its debt as a result of the adverse impact of the environment. Constant changes occurring in the markets (especially financial), forcing the company to make their own policy on the concept of risk, and thus the development of a logical set of behaviors, which should take the form of a decision-making process, a process called risk management. The structure of such a process must be as follows:

- risk identification,
- risk assessment,
- risk management,
- observation and control.

The business financing strategy is one of the important areas of business decision making. It determines the size of current and future financial needs related to economic activity and determines the most advantageous (from the point of view of expenditures and effects) source of funds necessary to meet these needs. When deciding on a financing strategy, decisions concerning the share of the use of own and foreign funds are essential (Ickiewicz J., 1996, p. 13). There are two main methods to take into account the capital cost of risk level. One subjective but practical application, the other objective but theoretical. The subjective risk accounting method (Ostaszewski J., 1999, pp. 30-31) consists in multiplying the cost of capital by the subjective risk index. The subjective risk index is influenced by factors such as: uncertainty about the development of a particular economic sector, uncertainty over the barrier to demand, uncertainty about operating profit and cash flow generated, and the possibility of repayment of outstanding credit obligations. The quantification of subjective risk is very difficult. Assistance may include the introduction of risk classes, such as very small, small, medium, high risk and very high risk. Each class should be given the appropriate weight, e.g.: 1.1, 1.2, 1.3, 1.4 and 1.5. Descriptive risk elements are then assigned specific numbers corresponding to one of the five risk classes. Such quantified features, which affect the level of risk, sum up and divide by the number of elements taken into account. In this way, you can establish a subjective risk index.

Risk-taking in the company's business and thus in shaping the structure of finances is an estimation of the risk of achieving a certain cash flow from operating, financial and investment activities. The right way to take into account the risks, uncertainty as to future cash flows, is to study their distribution, depending on a variety of factors affecting future cash flows (and therefore the factors implied by financial results).

Investing in a company depends on capital, which the company has and the possibility of obtaining additional capital. The cost of using a source of financing is the discount rate in NPV. In addition to the impact on cost of capital, the method of financing the investment also has an impact on the generated cash flow, which attributable both to owners and to creditors (Figure 1).

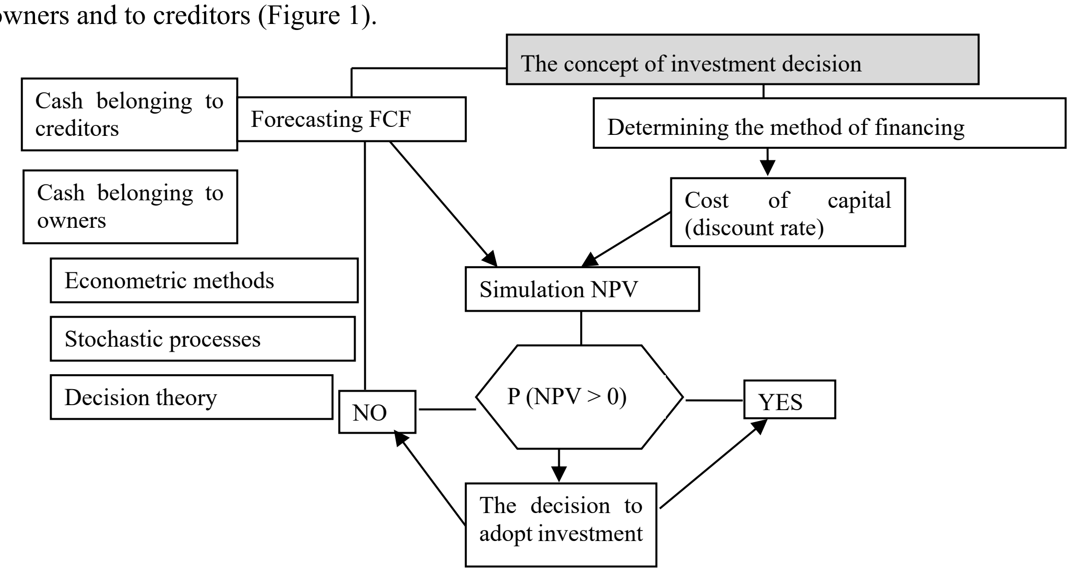

Figure 1 Methodology Dynamically Adapt The Structure of Corporate Finance in the Investment Process

The basis of methods for estimating the profitability of investment projects are developed by them CF_t cash flows. Forecasting cash flows, we rely on econometric or stochastic methods depending on the occurrence of time-dependent randomness. In NPV method cash flows are discounted and respectively compared with capital expenditures. WACC is assumed as the discount rate. The cost of capital is dependent on the method of financing. Simulation NPV deal with forecasting CF and possible combinations of WACC. Simulation results are the basis for elimination from further consideration of projects with NPV < 0, unprofitable projects.

5. Summary

One of the factors affecting the current financial results of the company and the profitability of its development projects is the financial structure of the company and its associated sources of financing. Financing strategy is a set of rules of behavior of an enterprise in the process of raising capital (Jog V. & Suszyński C., 1990, p. 261). Strategic decisions in this area are about finding the right relationship between equity and the alien. The financial leverage and the risk of default (bankruptcy) are at the heart of optimizing the level of debt. The optimal capital structure is one that allows for a balance between risk and rate of return on equity, and thus optimizes the price of the share capital. At the same time, the optimal financial structure minimizes the weighted average cost of capital and maximizes the value of the business. The increase in the market value of the company and the wealth of its owners as a result of the change in equity to interest-bearing liabilities proves that financial decisions taken in an enterprise should not be limited only to finding the cheapest sources of capital to finance operating activities. The use of family business operations by various types of financial transactions, which alter the company's existing financial structure, can also be an important element in maximizing the value of an enterprise and the benefits that its owners have.

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