



# FAME

**Family Business**  
Sustainability  
and Growth

## *Module 2*

**Entrepreneurial Finance**

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## Introduction

Family businesses form the backbone of the SME sector in every country. Those founding a new business entity usually need sooner or later support from their family members let it be their knowledge, money, assets, time, or simply understanding and personal care. Thus, it is vital that we enhance not only the survival but also the success rate of these firms. Our teaching material aims that by offering a detailed introduction into the financial issues related to family business. While we expect readers to have a basic overview of corporate finance, financial and managerial accounting, we strived to add short review of the basic concepts taught earlier and applied in our text.

Our module consists of three main sections. First, in Corporate Finance we will review issues that entrepreneurs will face as a top-manager in a family business. The second part, Personal Finance concentrates on challenges an individual will have to overcome in her/his personal life if (s)he becomes the (fellow) owner of one or several firms. Finally, in the third part we will look at the family business from the point of the society to list and review possible financial ethical problems connected to the owners of the operation of the family owned companies.

### Module Objectives

There are definite learning objectives (“LOs”) of the module. By studying the Entrepreneurial Finance module readers should be able

LO1: to demonstrate a critical understanding of the role and structure of family businesses in the economy,

LO2: to evaluate the usefulness of common financial accounting and performance measurement practices in case of family businesses and recommend adequate modifications,

LO3: to compare typical financing sources and strategies of family business to other types of firms,

LO4: to analyse and evaluate main business valuation issues emerging when dealing with family business,

LO5: to present and analyse the key challenges of personal finance for family business owners,

LO6: to address ethical issues characteristically developed by family businesses.

## Key Concepts:

This teaching material reviews among others the following issues.

- Economic importance of family businesses
- Value based management
- Financial reporting and analysis
- Working capital management
- Investment policy
- Financing techniques for family businesses
- Taxation and dividend policy
- Performance management
- Business valuation
- Exit strategies
- Wealth management for family business owners
- Estate and succession planning
- Ethical challenges at family business

We sincerely hope that reading this material will not only be useful in your professional carrier in the future, but gives you immediate inspiration, will also promote the general idea of entrepreneurship and push you look for further challenges in the beautiful and exciting field of finance. We wish you a safe and joyful journey through the family business adventure.

November, 2017

the authors

## SECTION I: Corporate Finance

The first part of this module focuses on the potential financial challenges within a family business. After reviewing the economic importance of these companies (Chapter 2), we provide an insight on how to create shareholder value by running them as a top manager (Chapter 3). Then, in Chapter 4, accounting and controlling problems will be covered to show the difficulties of getting exact and detailed information enough to follow the strategy picked.

Chapter 5 focuses on the operational issues of the everyday functioning. How to set the target amount of liquidity; how to manage your outstanding receivables; when to pay your suppliers? Which projects are good enough to invest in; and how to measure the embedded risk? Once we know how much capital we need for a smooth operation and to launch some new projects, we need to look for adequate financing. Chapter 6 will help us with that. Chapter 7 describes what to pay attention to when considering tax burdens, and explains how to decide on the right amount dividend.

Now, that we have our family business up and running, we can take a step back and review how to monitor and improve the performance of the company (Chapter 8.) Next, Chapter 9 will give us finally the big picture. How does this all make us rich? How to measure shareholder value? How to figure out the fair price to pay for an existing enterprise?

Still, life is changing. Entrepreneurs will grow older, they preferences may change, and their personal life might turn upside down from one day to the other. Can they leave their companies without jeopardising the existence of those? What should be take care of in such situations? Chapter 10 gives the answers.



## UNIT 1: Getting to know family businesses

Family businesses are the oldest and most common form of economic organization. (Huang et al., 2015) There seems to be a consensus in the literature that family businesses represent the most common form of business organisation around the world. (Gomez-Mejia et al., 2011) Mussayeva et al. (2016) estimate the family businesses around the world employ almost 30 percent of the total workforce of our planet and produce up to 45 percent of the global GDP. However, the share they represent varies heavily according to the definition used, the industry investigated, and the country considered.

In Asia and the Middle East, for example, family businesses cover 95 percent of the total of the companies. In Slovenia, their share in all firms is between 41 and 51 percent, while for the whole region family firms represented 38-50 percent of all SMEs (Vadnjal, Kociper, and Letonja, 2010).

According to US statistics, there are almost 24 million US family businesses, so 80-90 percent of US businesses are family businesses, and their contribution to the GDP exceeds 64 percent. (Mussayeva et al., 2016) Considering the listed companies only, family businesses add up to roughly 70 percent of all publicly traded US companies, and they employ 80 percent of the workforce. (Huang et al., 2015)

Their share might even reach as high as 95 percent in some industries like construction. (Gomez-Mejia et al., 2011) While usually family firms are small, in the US those make up about one third of the listed firms of the S&P 500 and Fortune 500 indices, and nearly half of the Fortune 1000 companies.

History and regulation plays an important role in this ratio. When considering the top 100 companies (based on 2005 sales), the proportion of family businesses was 50 percent in Mexico, 18 percent in Brazil, but barely 1 percent in China. This later low rate is explained by the state owning the 95 percent of the top Chinese companies. (Fernández-Pérez and Fernández-Moya, 2011)

In some regions, the economic role of family businesses is still before a dramatic rise. Mussayeva et al. (2016) emphasise that by 2050, small and medium businesses would produce at least 50 percent of Kazakhstan's GDP, instead of the 20 percent in 2014. They believe running a small business should become a family tradition, passed on from generation to generation. Passing over the family business is a form of keeping people employed in areas where the number of other workplaces is limited.

Also Stough et al. (2015) assume that family firms contribute differently to regional development than other companies. The social embeddedness of family businesses is usually much stronger than that of their counterparts so family firms could play a more dominant role in regional economic policy.

Basco (2015) underlines that building a regional development policy on enhancing family business activity has both positive and negative consequences. Family business may be

good at decreasing distance between the society and the firms, and could build stronger personal relationships with strategic partners and reinvest more locally than other firms do. At the same time, their lower R&D activity, their operation built on personal networks and their weaker efficiency may lead to lower adaptation to global challenges, stronger dependence on regional tendencies (little diversification), and could miss taking benefit of local knowledge centres.

To conclude, family firms play an important role in the economy and are not limited to a region, an industry or a certain size category. While those companies are present everywhere, as we will see in this teaching material, they have their own specialities. We need to be aware of these unique characteristics, to efficiently regulate, own, manage, cooperate with or work for those firms.

### 1.1. What is a family firm?

Family firms are owned by a family, are they not? Well, that is not that simple. Yes, we need to have some ownership belonging to a family member, but definitions usually also ask for at least one other family member to be active in the business. Nevertheless, there is hardly more definitions agree on. If I work for a listed company my father holds one share of, does that already make it a family company? For sure, not. What if I am the CEO? And how about my father owning 5 percent of all shares? What if my mother owns another 15 percent? It is hard to set the required minimum limit.

Why is it so hard to give one unique and clear definition? On one hand, families may own their company in various ownership structures. (Goel, He, and Karri, 2011) The most common are the following.

- (1) Direct ownership. Family members hold the shares of the family business.
- (2) Family holding company. The family members own shares in a single holding company, which owns family related business as subsidiaries.
- (3) Pyramidal structure. The main holding company holds shares in some other firms that own other subsidiaries.

(4) Cross-holding. Family members own shares in several companies personally but these companies have also cross ownerships among them.

Because of the existence all these options (and their possible combinations), it is already pretty hard to figure out which company is held by a family. Just looking at the legal records may not help, as you may need to research owners and the owners of owners up to several levels to end up finding members of the same family, which gives at least one of the key decision makers of the company.

On the other hand, a certain amount of ownership may give you an important influence in one company but probably none in another. Owning just 10 percent of a private company could put you in a very vulnerable minority shareholder position if the rest of

the shares is held by let us say a professional strategic owner like a multinational enterprise. But if you own the same 10 percent in a listed firm with every other owner having less than 0.1 percent stake, probably you will be elected to be president of the board, and would have nearly full control over the business.

As seen earlier, family businesses even appear among the biggest firms. Excluding 97 banks and public utilities, founding families are present in 141 of 403 S&P 500 firms. But they are far from being the only owner. Once you check their holdings, on average, "only" about 17.9 percent of equity stakes and 20 percent of the board seats in these firms belong to them. (Chansog et al., 2014)

The typical extent of family ownership may differ radically across the world. While in developed countries, definitions consider a company as family business when a family owns more than 20 or 30 percent of it, in Mexico the ownership of the controlling family in a family business is typically at least 50 percent. (San Martin-Reyna and Duran-Encalada, 2012)

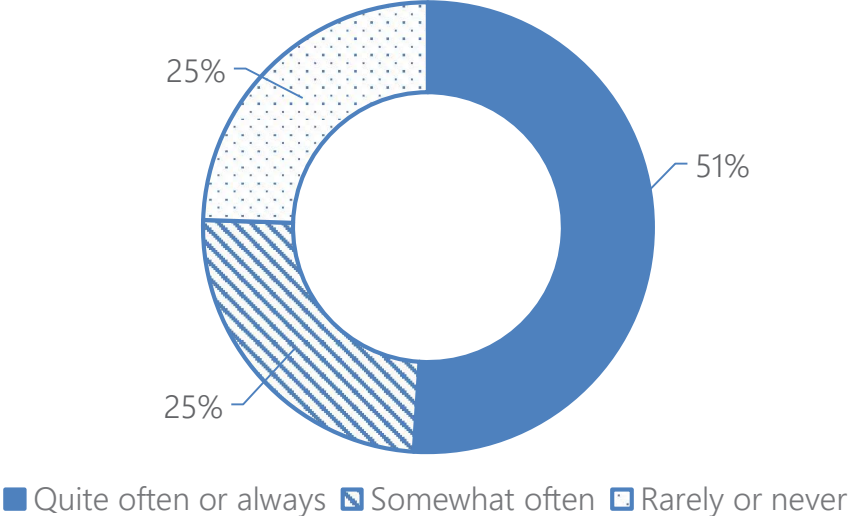
Family firms are typically owned by just a few shareholders. For example, the majority (76%) of family firms in Slovenia have a single owner, while 18 percent of them are owned by to individuals. (Vadnjal, Kociper, and Letonja, 2010)

La Porta et al. (1997) emphasise that the legal system of a country would have a strong influence on the ownership structure. While civil law countries usually offer limited protection to minority shareholders, common law protects them more extensively. This is why in civil law countries families tend to hold bigger proportion of their businesses (greater concentration of ownership), while common law countries have higher ownership dispersion.

Cultural, historical, and political effects are also key for Fernández-Pérez and Fernández-Moya (2011) who compared largest family businesses (members of the top 500 in their country) in China, Mexico, and Brazil. They conclude that the oldest big family businesses are to find in Brazil, while the youngest come from China. However, the highest profitability is recorded in those from Mexico.

Industry focus is also different. Biggest family enterprises of Brazil are active in the food, retail, construction, and energy sector (very similarly to the US). Those in China specialise on electronics, retail, and car parts, while Mexican giants focus on IT, communication, and media. They found that the critical factor in these development trends was the accumulation of professional managers.

Figure 1 Do you refer to the fact that you are a family company in your corporate communications? – World biggest 2400 family businesses



Source: Ernst & Young (2017, p. 11)

As we will see in this teaching material, there are a number of unique traits of family business when you analyse their governance, strategy, operation, or market behaviour. But is it important for the market players of eth business itself that the firm could be seen as a family entity? Based on a recent research of Ernst and Young (2017), 76 percent of them would emphasise this fact, as it is very often seen as a positive characteristic on the market even in case of the biggest enterprises. (Figure 1)

## 1.2. Setting up your business

The role family businesses play in a given economy could be only understood once the historical trends are considered. This historical path dependency may also explain some of the differences across regions.

For example when describing the situation in Estonia, Kirsipuu (2011) underlines that during the socialist area all earlier family entrepreneurship were nationalised and it was only after the democratic change in the early 1990's that new ones could be founded. The real boos still came with the EU membership of the country in 2004. Vadnjal, Kociper, and Letonja (2010) also mention that before 1990 private ownership (and thus any family business) was limited to small craft shops, restaurants, and farms in Slovenia and other transition countries.

Markoski and Gosevska (2012) analysed the role of family businesses in the economic development of Macedonia and call the attention to the fact that high percentage of family businesses in a country is not only linked to the local entrepreneurial attitude. Rather, it might be caused by the pressure of unemployment, low wage levels, or poor management quality at existing companies making employment with them not very attractive. If an individual possesses not the total of the necessary capital or workforce, the newly found company will soon be a family business.

Table 1 Most important motives for starting a business

(relative importance, Slovenia)

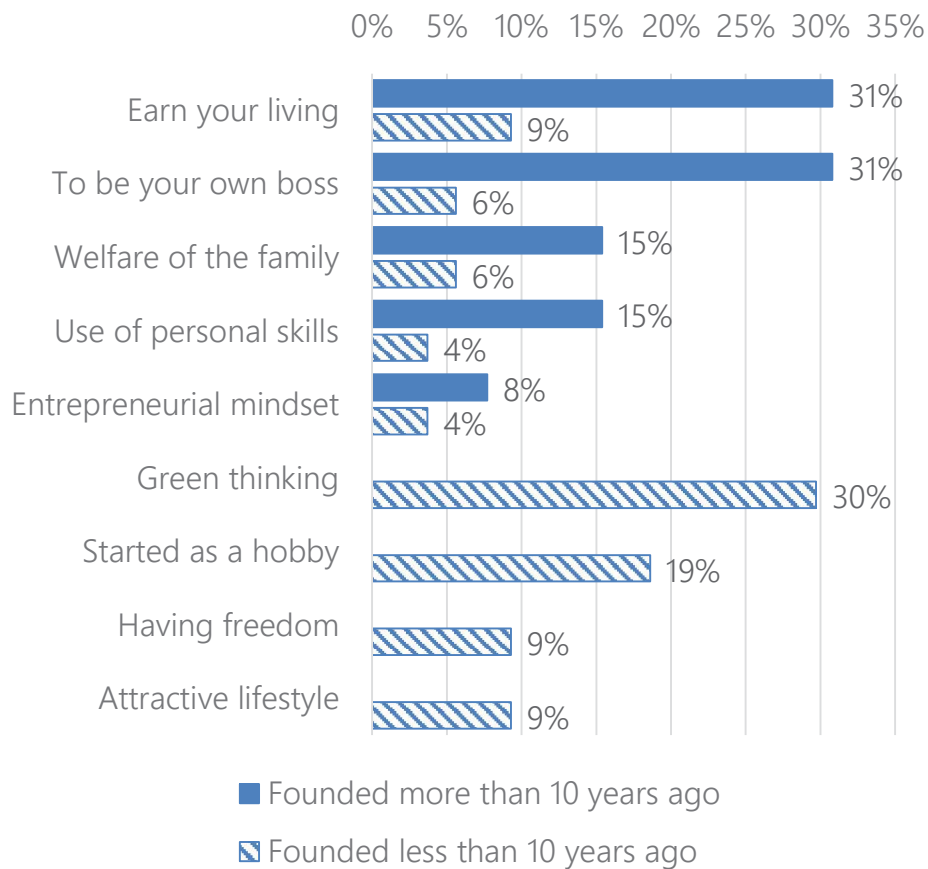
	Family firms	Nonfamily firms
The possibility to implement own ideas	4.21	4.25
To do what you desire	3.78	3.93
The opportunity to learn and develop	3.78	3.89
Exploiting business opportunity	3.74	3.74
The opportunity to build a team	3.35	3.44
Personal security and job ensured	3.35	3.07
Flexible working time	3.23	3.07
To increase wealth	2.73	2.77

Source: Based on Kotar (2006, not published) cited by Vadnjal, Kociper, and Letonja (2010, p. 171)

Citing an unpublished paper Vadnjal, Kociper, and Letonja (2010) highlight that the importance of the reasons behind starting a family business are quiet similar to those for setting up other firms. (Figure 2) At the same time, we see less emphasise on personal motives but more on creating a job for yourself and to achieve flexible working hours.

Kirsipuu (2011) showed that motives for setting up a family business can vary radically over time because of both cultural and economic changes. In Estonia, entrepreneurs setting up family businesses more than 10 years before his research in 2011 have picked radically different reasons to start their business than those with less than 10 years of history. (Figure 2)

Figure 2 What was the key motive of starting your family business?



Source: Based on Kirsipuu (2011, p. 74)

While in the early 1990's after the democratic change the main motivation was unemployment, wish for independence, and the poor wage level available as an employee, the recently appeared green thinking and living for your hobby became already more important than those old ones.

### 1.3. Success factors and challenges of family businesses

What makes a family business successful? While based on the theory firms should focus on maximising shareholder value, it is not straightforward what the owners of a family business consider as value. It is clear that the non-monetary socioemotional wealth is far more important in case of these companies than for their counterparts. (For more on value based management see Chapter 3.)

Based on an unpublished Slovenian research Vadnjal, Kociper, and Letonja (2010) list five main criteria that needs to be fulfilled so that owners consider a family business successful. Those are the following in order of importance.

- (1) Family members are able to separate their family roles from their position in the family business.
- (2) Transition of the business into the next generation is successful with no serious troubles.
- (3) The firm is able to satisfy the personal and financial goals of family members.
- (4) The sales of the business steadily increases.
- (5) The company realises the vision of the founder.

Now that we see what makes family businesses successful, we should understand what challenges they face while trying to get reach those goals. Kirsipuu (2011) performed a huge questionnaire based research in Estonia during the years 2008 to 2011. Based on his results, the main problems of family firms were (1) insufficient funding, (2) shortage of skilled labour, (3) lack of entrepreneurship knowledge, (4) shortage of time, and (5) difficulties in marketing.

Vadnjal, Kociper, and Letonja (2010) present problems of the Slovenian family business. (Table 2) On this rather family oriented list once again shortage of time and lack of knowledge appear.

Table 2 Problems of Slovenian family businesses as ranked by different generations

Rank	Issue	Founder	Heir
1-2	Disagreement in business as the source of personal conflicts	2.7	2.2
1-2	Business is also discussed during free time	2.7	2.6
3	Unable to separate business and private affairs	2.8	2.7
4	Family members do not have the know-how needed	2.9	2.8
5-6	All problems are solved within the family circle only	3.0	3.1
5-6	All family members are not equally interested	3.0	3.0
7	We are not successful in co-ordinating family and private roles	3.1	3.0
8	We too often leave problems to be resolved by themselves	3.2	3.6
9	All problems come from the outside (market, governments)	3.3	3.5
10	We do not have formal decision-making system	3.4	2.9
11	Some family members are not interested in the business	3.6	2.9

Source: Based on Wadnjal (1996, not published) cited by Vadnjal, Kociper, and Letonja (2010, p. 175)

Analysing the neighbouring Serbia, Stevanovic (2014) lists further challenges of family businesses. The (1) lack of financial knowledge, the (2) competition of the grey economy, (3) high taxes, (4) non-cooperative authorities issuing high penalties, and (5) uncertainty due to fast changing laws and regulations make the life of the entrepreneurs harder.

The required steps to promote and support family businesses are very similar in most of the countries. For example, Kirsipuu (2011) concluded, that Estonian family businesses need for their development among others

- (1) entrepreneurship training courses,
- (2) help on management transfer to descendants,
- (3) cooperation and social activities in rural areas,
- (4) aid to find supplementary funding, and
- (5) cooperation between local governments and family businesses.

Based on her expertise from Serbia, Stevanovic (2014) adds (1) making authority activity more preventive and not focused on penalties only, and (2) promoting the lawful and ethical entrepreneurial behaviour.

Education is one of the key success factors also in Mexico, China, and Brazil. Fernández-Pérez and Fernández-Moya (2011) underline the key role played by good management schools that make it possible for family business to have access to well-trained managers and professionalise their organisation.

Based on their analysis performed in Kazakhstan, Mussayeva et al. (2016) highlight that for those who intend to start a family business need (1) legal support, (2) loans and also propose to offer (3) tax credits based on the number of children in the family taking part at the business activity to reflect the value of jobs created.



## 1.4 Conclusion

Family businesses play an important role in the economy everywhere over the world, but there could be significant differences in their proportion and performance depending on historical, social, and political traits of the given country. Because of their unique characteristics, family businesses may be better in answering some of the challenges of the regional development policy, but it seems that concentrating just on those could create an unhealthy structure.

Goals and problems of the family businesses are very similar no matter where we go. Maximising profit receives less focus, rather when deciding, both monetary and non-monetary (socioemotional) wealth parts are considered, healthy life-work balance is required, and smooth succession is also among the prerequisites to categorise your family business as successful. Limited management knowledge, difficulties in funding, low access to information and cooperation networks, and issues of family based decision-making call for some outside support almost everywhere.

## 1.5. Reflective Questions

1. What do you think the prerequisites for a company to be classified as a family business in your country could be?
2. What makes a family business successful for you?
3. What do you think currently the key challenges of family business in your country are?
4. 4. List reasons and ways the state could promote family business activity in your country.

## UNIT 2: Value based management at family businesses

Value based management (VBM) is a management system aiming to achieve that a company acts in the best interest of its shareholders by maximising the value generated for them. Usually, we have to tackle two main challenges.

(1) There is a conflict of interest between the shareholders and the management. The capital provided by the owners should be managed in their interest while for the executives there is a strong temptation to serve their own interest. Corporate governance is the mechanism to provide adequate control and overview over the management work for the shareholders and motivate the executives to perform to their best.

(2) To achieve that the whole organisation acts to maximise shareholder value we need a management system including decision making, communication, motivation, control and education. In other words, we also have to deal with the agency problem between employees and the management. (In some texts, VBM refers only to these tasks.)

This chapter reviews these two areas and offers insight to specialities of family business. It is vital to see that VBM is about to find the best ways to create shareholder value and not about measuring it. Valuation will be dealt with in Chapter 10.

Theoretically, setting up an integrated VBM system should be one of the first steps once setting up a new business. However, as usually at the start firms have only a very limited number of employees these agency problems do not yet emerge (the owners, the managers, and the employees are the same individuals) companies start to think about VBM only once agency problems start to emerge. Then, we do not only have to set up the right system but also have to manage an organisational change process with serious effects on the culture. This is why introducing and fine-tuning a VBM system may take several years and might lead to serious personal conflicts.

### 2.1. Corporate governance and organisation

It is vital to see that shareholder value means not just money in some form. Gomez-Mejia et al. (2011) call the attention to the fact that the identity of family members is closely linked to the firm. The personal pride, image and self-concept of (even passive) family members tends to be tightly tied to the business, which often carries even their name.

Due to this, just like in case of single entrepreneurs, we should keep in mind that beside of the monetary wealth there is a considerable amount of socioemotional wealth generated by the family businesses for their owners. Therefore, whenever considering value generation, decision makers have to estimate effects both on the monetary and socioemotional parts of family wealth. This later connects members of the wider family (carrying the same name) even if some of them are neither employees nor owners of the

business. Beside the need of using always this more extended shareholder value concepts, there are several specialities of corporate governance typical for family business.

(A) Principal-agent problems. It is hard to construct an adequate corporate governance system for a family business as there are various principal agent problems arising within it. We may have one

- (1) between the members of the wider family (with the same name but other business interests) and those owning and controlling the given company,
- (2) between active (employed by the family business) and passive family members,
- (3) between family member owners and external owners (majority vs minority owners),
- (4) between owners and managers,
- (5) between managers and employees,
- (6) between the firm and any lenders.

In case of nonfamily firms, we usually find the last three of the principal-agent problems listed, so general theory would mainly focus on those. It is very important, that these agency problems are consequences of information asymmetry and moral hazard. If owners act as managers and employees these shortcomings are radically decreased, thus family involvement should improve business efficiency by cutting back on monitoring cost significantly.

If these last later agency problems might still rise, that happens usually differently than in other types of firms and may call for alternative solutions. For example, family executives seem to be protected from performance accountability that is key in contract theories seeking solution for agency problem (4). Family executives tend to serve on average three times longer than non-family top managers even if the business performance is poor. (Gomez-Mejia et al., 2011)

Goel, He, and Karri (2011) underline the cultural aspect of hidden conflicts among family members, that is agency problems (1) to (4). For example in the Chinese culture, disputes should not be resolved openly and differences of opinion remain often hidden as due deep respect to elders confrontation is to be evaded. Nevertheless, conflicts remaining below the surface may result in weaker motivation to work diligently and wholeheartedly. Frustrated family members may be less innovative and creative, and would only follow orders instead of taking initiative. This may lead to loss in business performance. To resolve this problem, one option is to involve several family members in the top management where they can more easily confront opinions.

To resolve principal-agent problems (1) to (4) where on both sides family members are involved Michiels et al. (2015) propose the use of family governance practices (FGP). These are formal or informal rules and processes accepted by the family members to share information, opinions, take decisions, and sort out any conflict among them. FGP may change overtime adopting to the need of the current generation. The aim is to create a shared vision of family members and to sort out any information asymmetry. Organising

family forums even with changing compositions is a classic method for increasing transparency and coming to decisions that can be later presented to the nonfamily management as a family decision.

The composition of a family charter could also be of great use. This document sets the rules of sharing information and resolving conflicts in a written form. The paper may set even rules for very specific decisions like number of seats in the board for specific parts of the family, fair compensation of active family members or minimum of dividend payment and reinvestment. A family charter approved by all family members could strengthen the family culture and image radically, increase stability and lead to more smooth and long-term focused running of the business, and thus, may create additional value for the shareholders.

Jin and Park (2015) focused on potential agency problems between family and nonfamily owners. They analysed 121 publicly traded firms belonging to 35 huge Korean family groups (Chaebols) for the period from 2003 to 2010. They concentrated on separation of voting and cash flow rights and showed that it had positive market valuation effect on the companies examined.

They underline that for stand-alone firms this separation may really be against the minority shareholder's interest, but in case of family groups additional rights of the owning family could even benefit them. (Earlier worldwide research papers were contradictory as not only found no or negative, but also positive connection between market valuation and separation.) Positive effects include at least three factors.

(1) Family managers care more for the fairness as they have to protect the total wealth of the family and any misuse of resources may not only negatively affect the socioemotional wealth (the fame of the family) but due to their personal connections the family group could be found also legally liable for the activity. Therefore, frauds are less likely if a family is ready to provide a family manager for a firm.

(2) The classic argumentation that additional controlling rights could promote expropriation of wealth assumes short-run focus of the owner while family owners are characterised by long-term view. Thus, additional family control may increase the probability of long-term survival of the firm.

(3) They highlight that dominant family control over a firm the capital of which would only come from the family itself to a smaller proportion may be the result of taking benefit of intra-group financing market. If a capital rich family enterprise with external shareholders provided equity financing of an affiliated company, the later firm may get also under family control while just a limited part of the future cash flows (dividends) will get to the family itself. Thus, recording family control over a firm where family ownership is moderate may mean advantages (and not disadvantages) received by the company.

(B) Role of the board. First, we need to see that different legal systems offer different governance opportunities. The common law (Anglo-Saxon) governance model a board is overseeing the company some of the members of which are also involved in the daily management. In contrast to that, the civil law (continental) model requires the owners to choose a supervisory board to overlook the activity of the management, and a CEO who will be responsible of choosing the members of the management taking both strategic and operational decisions. Most of the empirical investigations focus on markets using the Anglo-Saxon model.

Based on a wide literature review Van den Heuvel, Van Gils, and Voordeckers (2006) tell apart four roles of the board. (1) The *control* role involves overseeing the executives, particularly the CEO to assure that their act in the interest of the shareholders and do a good job in managing the operation. (2) *Strategic* role refers to the board members offering a wide range of professional expertise to promote top quality strategic decision making. (3) The *service* role covers representing the company and its interest in the community and providing valuable access to their network. Finally, (4) *resource dependence* role includes providing legitimacy, connection to the key shareholders, facilitating access to resources and new external connections, and improving the public image of the firm.

To learn which of these functions is most important, Van den Heuvel, Van Gils, and Voordeckers (2006) examined 286 Belgian family SMEs. They found that in these firms boards were expected to fulfil only the service and the control functions. This means that companies do not hope to receive strategic advice while based on theory that would be one of the two key tasks of the board. They also learned that family CEOs consider the service role of the board as most important, control is only secondary. However, top managers are not happy with that status and would need more support from the board in directing succession, evaluating management, building organisational reputation and providing strategic advice.

Gomez-Mejia et al. (2011) found that in case of family businesses, family member board members tend to use their power to influence executives to serve aims of the family not that of the shareholders in general. In addition, family firms tend to employ less external board members to enhance (keep) family influence.

Di Carlo (2014) prepared ten case studies on Italian family business groups owning 28 listed firms to check on this phenomenon. He concluded that while most of the firms (20) stated acting independently from the family holding owning them, based on the board composition (number of family members included) this was only likely in one single case. Di Carlo underlines that there are at least two reasons why those companies do not publicly recognise family control. Subsidiaries wish (1) to persuade the outsiders that there is no risk of extractions of private benefits by the dominant shareholder; and (2) they wish to exclude the parent company from any liability in the case of damage caused to outsiders (e.g. minority shareholders and creditors). He emphasises that this apparent

independence could be interpreted as a negative sign by the market. This is why he calls for adequate number of truly independent directors in the board so that they would be able to block any trial from the majority family owner to expropriate wealth.

At the same time, the number of active family members seems to depend not only on the characteristics of the firm but also on that of the family itself, especially on its size. Based on a research focused on the 93 biggest business families of Thailand, Bertrand et al. (2008) identified a strong positive connection between family size (particularly the number of sons the founder has) and family involvement in the ownership and control of the family businesses. The sons of the founders play a central role in both ownership and board membership, especially if the founder of the group has died.

Interestingly, bigger involvement of sons is also associated with lower firm-level performance, especially when the founder deceased. They assume that this decrease in performance could be due to the competition of possible heirs for the top position. In line with that, Gama and Galvão (2012) call the attention to the fact that family firms often have to deal with family issues, which might be very resource-consuming.

Examining 163 listed Chinese family businesses from 2001 to 2005 Goel, He, and Karri (2011) underline, that there could be also a contrary effect of several family members being involved into the management. If several family members are active in the firm any negative consequences of concentrated power (risk a failure, dependence on one individual, conflicts among active and passive owners) can be decreased. They measured the level of involvement with years spent with the firm and showed that having several family members with similar level of involvement in the firm leads to higher business performance. They emphasise that in cultures like the Chinese where non-confrontational approaches are preferred in case of conflicts and opinion of elderly should not be questioned dispersed control would promote sharing opinions and resolving conflicts directly. Thus, negative effects of in-family conflicts would not reduce efficiency of the firm.

The optimal structure of the board seems to be different for family and nonfamily firms. San Martin-Reyna and Duran-Encalada (2012) investigated data from 90 listed Mexican firms for the period from 2005 to 2005. They concluded that for nonfamily businesses, where the shareholder have no direct control over the firm, level of indebtedness (implying strong monitoring from the banks) and the number of outside directors (independent monitoring of shareholder interests) both have a positive effect on the business performance (market value). At the same time, the same factors affect negatively the market valuation of family businesses, as those control mechanisms are likely to be substituted by the presence of active family members, and add transaction costs only. This could be the reason why only 20 percent of Mexican firms have a majority of external board members and even those members are often related somehow to the same business group belonging to the owner family.

(C) Incentives of executives. Family firms tend to underpay their top managers. Empirical results show that there is an inverse connection between the family ownership concentration and the payment level of the CEO. In exchange, CEOs have a relatively stable job, are less likely to be considered incompetent by family board members, and see an increase in their position within the family (increase in personal socioemotional wealth). (Gomez-Mejia et al., 2011) In some SMEs, higher dividend received may be used as additional compensation for lower wage for the owner-CEO to take benefit of tax advantages.

Memili et al. (2013) investigated data of 2019 small US family firms to show that family ownership, family management and intra-family succession intentions are all negatively associated with the propensity to use incentives for non-family executives. At the same time family owned business without a family member in the management tend to use incentives more intensively than other family firms do.

(D) Relationship to stakeholders. Family businesses have also specialities when considering stakeholders. (Gomez-Mejia et al., 2011) First, the family in a wider context steps in as unique individual stakeholder. In addition, empirical research show that family businesses are more open to outside requests from stakeholders as family decision makers consider also possible loss to their socioemotional wealth.

Eleni, George, and Alexis (2007) researched downsizing and stakeholder friendly practices of Fortune 500 companies to see whether family businesses care more for their employees and community. They found that family firms downsize to lesser extent irrespectively of their financial performance. While there were also more family business involved into charitable giving and family benefits to employees, no significant connection between these activities and the extent of downsizing was found. It seems that family business caring more for their stakeholder has little to do with moderate downsizing rather that could be possibly explained by trying to protect and maintain the socioemotional wealth (image, fame) of the family.

(E) Corporate Social Responsibility (CSR). Empirical results show that family businesses tend to exhibit more social responsibility and adopt environmentally friendly strategies more frequently than their counterparts (Gomez-Mejia et al., 2011). Evidence was also found that family firms are more likely than nonfamily companies to avoid actions that might cause them to be labelled as socially irresponsible.

El Ghoul et al. (2016) investigated CSR activity of listed firms in nine East-Asian countries and learned that family controlled firms exhibit lower CSR performance. This in line with the theory of expropriation based on which family socioemotional wealth is increased by performing humanitarian and philanthropic activities personally rather than under the name of a public firm. Unfortunately, this could be not the only explanation as CSR underperformance concentrated on family businesses with more extensive agency problems and countries with weaker institutions like minority shareholder right protection.



## 2.2. Executive selection

The most important executive selection decision is always to choose the CEO. As usually it is the family member founder, who is the first CEO of the company, the selection of the next CEO emerges as a succession problem. Although, we have to see that it is not necessary that the same individual inherit both the ownership and the top management position.

When deciding about the top-manager family businesses usually face a kind of limited choice (Gomez-Mejia et al., 2011). Owner-managers choose their successor by considering the socioemotional wealth of keeping the family control even if better candidates are available from outside of the family. (Succession issues are covered in more detail in Chapter 11.)

It seems that family member COEs consider finding and training adequate successors from within the family as a personal contribution to the (socioemotional) wealth of the family. This might be the reason why family business comparing to non-family counterparts put more emphasis on preparing the candidate though outsourced trainings and building strong personal ties between both the successor and the current leader, and the successor and other stakeholders of the business.

We may also experience that family CEOs see stepping back as a far bigger personal loss than other top managers. As they very often spend most of their life with the same company to achieve their current position, there will be a heavy loss in their social status and power. Due to that family CEOs often care less for succession driven by a hidden wish to stay at the top of the firm as long as possible what may not serve the best interest of the firm and the total of shareholders.

Professionalization is the process during which managers and specialists are hired from outside of the firm and more formal management structures are introduced. Research results show that family businesses are reluctant in professionalization (Gomez-Mejia et al., 2011) as family managers are unwilling to delegate responsibility to outsiders. This tendency is even present to some extent at listed firms.

At the same time, these results may be also due smaller average size and so having less resource to pay market level wages to outside managers. In addition, in case of owner-employees dividends that might offer a tax advantage compared to other compensation methods, may be substitutes in some extent to wages, what is not true for executives hired from the market. This is why special care should be taken to control for size effects when comparing wage level and professionalization.

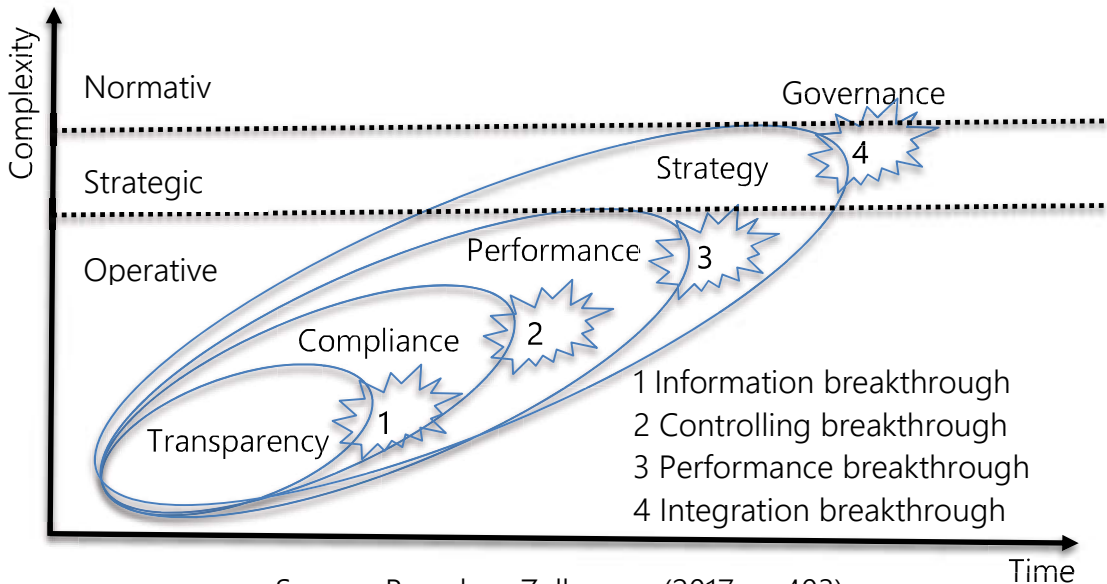
Nonfamily managers provide external knowledge for the firm. (Hiebl, 2014) However, when hiring them, formal qualifications are mainly in focus and the importance of cultural competence is often underestimated. This leads to conflicts during their later career with the family business.



Chief financial officers are usually the first nonfamily managers to be hired by family business. (Hiebl, 2014) The CFO position needs highly specialised skills the owning families usually lack, and by hiring one from the market, the company may gain valuable knowledge resources and mitigate the risk and the effects of financial distress in difficult economic conditions. Research papers found positive association between the existence of a nonfamily CFO and the performances of small and medium-sized family firms, but not for bigger companies.

Zellweger (2017, Chapter 9) describes the process of integrating a professional CFO into the organisation of a family business. There are four breakthroughs to achieve so that all advantages of a professional CFO could be used. (Figure 1)

Figure 1 The evolution of the CEO



Source: Based on Zellweger (2017, p. 403)

There are several empirical result supporting that family business care more for their employees. Particularly firms with founder-CEOs show such a tendency. Huang et al. (2015) investigated the role of corporate culture on the value of family business. Based on more than 100 thousand employee surveys from years between 2008 and 2012 they found that employees of family business with active founders rate their company higher than those of other enterprises do. This effect is even stronger if the founder runs the business. At the same time, there is no difference if only family members are active in the firm, and there is a negative effect even once a successor runs the company. This is particularly important as employee satisfaction proved a good predictor of future financial performance.

However, family business are less formalized when it comes to human resource management (HRM). (Gomez-Mejia et al., 2011) They tend to rely more on social networks of the family and the founder particularly. The recruitment process often lacks clear criteria for screening applicants, but the new employee fitting into the current culture plays a more significant role. Informal training and mentoring is more important in family-owned businesses. Development plans tend to be longer in term and more focused thus strengthening the identification with the firm and its values. Empirical results also show that small family firms are willing to employ multiple family members even at the risk of lower profitability.

Based on an extended literature review Sharma, Chrisman, and Chua (1997) add to these that a number of research has found family members being more efficient employees than nonfamily members. However, hard working family members usually complain for underpayment and overworking. Other studies, though, found that some family members receive extra payment and preferential treatment within the organisation leading to conflicts with nonfamily member employees and HRM challenges.

Hiebl (2014) analysed hiring habit of family firms for chief financial officers (CFOs). He conducted 20 interviews with top management members of 11 Austrian firms. He concluded that formal education is less important for smaller family firms than their nonfamily counterparts. The tasks of the CFO often include the management of the personal wealth of the family in companies with high family influence, and thus these firms are more likely to hire a professional with additional knowledge of tax, law, and wealth management. (For more details on wealth management see Chapter 12.)

Family firms value any earlier nonfamily firm experience over experience gained at family firms as they hope to receive addition benefit from learning from nonfamily enterprises. Family firms tend to prefer same-industry experience more than nonfamily companies expecting a very fast integration of that.

Family firms put more emphasis on social and interpersonal requirements when hiring. Particularly long-term orientation and conflict moderation skills are required. This could be why candidates with family firm experience tend to integrate into the family business much faster than those without it do.

Promotions and wage levels tend at family businesses depend more on seniority due to considering loyalty more valuable, non-monetary compensation (flexible working hours, extra holidays) receive greater, while variable pay gets smaller weight than elsewhere. Very often performance is viewed as fulfilling family obligations, and compensation should contribute to family harmony. (Gomez-Mejia et al., 2011) Based on empirical results, informal channels are preferred over formal ones for communication with employees to keep familiar atmosphere.

### 2.3. Strategic decisions

Family firms are more likely to take a long-term orientation in making strategic investments than other companies. (Gama and Galvão, 2012) At the same time, Leach and Bogod (1999) emphasise that family managers tend to stick to earlier practices and their do not change processes, and thus the business model does not adapt to new challenges. Another huge problem of strategic decision-making originates from most family business managers being professionals but lack management training; therefore there is a shortage of process optimisation and leadership skills.

O'Regan et al. (2010) prepared 20 in-depth interviews with managers of family business under the control of the second or the third generation to learn more about strategic thinking in the companies. They conclude that strategic thinking (formal strategy building) becomes more and more important with newer and newer generations taking over the company.

Risk taking. Empirical results show that family businesses are less willing to take risk than other firms do, what is explained by the lack of diversification, or in other words, the owner's personal wealth is concentrated and so too much dependent on the firm. (Gomez-Mejia et al., 2011) The lower risk taking willingness may lead to missing good investment opportunities and weaker profitability (Gama and Galvão, 2012).

Diversification. Because of the severe concentration of the family wealth in the business, it seems to be logical to expect that family firms tend to diversify their activities across different fields, markets, and countries to reduce risk. At the same time, there are various counterarguments. (1) Extending activities to new areas or industries may need outside financing that implies losing some of the family control. (2) Diversification may also need special expertise not available in the family. Professionalization and hiring outside managers could also decrease the family control. (3) New products and markets may also ask for a change in the organisation that could be against the interest of some of the active family members and the conflicts raised could decrease the socioemotional wealth. (Gomez-Mejia et al., 2011, Schmid et al., 2015)

To see, which of the two forces is dominating, Schmid et al. (2015) focused on German listed firms from the period 1995 to 2009. They found that we should tell apart family ownership from family control. Firm owned by a family (holding at least 25 percent of the voting rights) but controlled by professional management have a higher level of diversification, probably because of executives realising the family wealth diversification problem. At the same time, for businesses with a family member in a top management position but the family owning less than 25 percent of the firm, the opposite was recorded. There probably the family member is more concerned about keeping the family control and saving the socioemotional wealth of the family rather than making it more secure. For family business with a family member in the top management no difference was found in diversification compared to other companies.

It seems, though, that there could be also a cultural and financing trait of the question. Zain and Kassim (2012) surveyed 108 Qatari family businesses and concluded that local companies are rather optimistic and see globalisation more as an opportunity not as a threat. Based on their results, the existence of an internationalisation strategy depends mostly on the availability of funding. This may imply that family businesses do not diversify internationally mainly because of the lack of funding or because they are afraid of the consequences of getting the funding (i.e. loss of control).

For smaller firms, the issue of diversification is far from being this simple. Kirsipuu (2011) carried out 1000 interviews with family business owners in Estonia from 2008 to 2011 and highlighted that all entrepreneurs believed that one single activity is not enough to achieve success. To diversify risk they all took up ancillary activities usually linked to skills and abilities of other family members. On one hand this process can be seen as a diversification of the basic activity, on the other hand the phenomenon may be classified as running two (or several) businesses with two (or more) independent family managers under one umbrella to save on legal and administrative costs and to share personal income among family members.

**Acquisitions and mergers.** It seems that family firms are less willing to purchase other companies. One possible explanation to this could be the lack of one of the key motivation factors for M&As, namely the intention to diversify. (Gomez-Mejia et al., 2011) Other issues might be the lack of funding (refusal of outside financing) and the risk involved in M&A transactions.

Basu, Dimitrova, and Paeglis (2009) investigated 2613 US firms for the years 1993 to 2000 and showed that companies with higher family ownership are better in acquisitions. Those earn a higher return when acquiring another company than those with lower family ownership do. The financing of the transactions also differs: entities with lower family ownership tended to pay by cash to evade dilution effect. When considering family firms as acquisition targets, results showed that low level of family ownership is associated with higher value creation. In other words, firms with higher family ownership are better managed and offer less room for efficiency improvement for the acquirer.

Shim and Okamuro (2011) investigated the link between mergers and family ownership. Based on a sample of 1273 Japanese mergers, they found that family firms are less likely to merge with other companies than nonfamily counterparts are, and family businesses take usually less benefit from these transactions than nonfamily entities. At the same time, family business with bigger family ownership are more likely to enter mergers.

**Leverage.** Gomez-Mejia et al. (2011) underline that in case of deciding about leverage family firms tend to consider several factors in addition to other companies. One of that is the change of socioemotional wealth (possible disputes within the family), and other one is the decrease in family control over the firm. (You may find more on financing issues in Chapter 7.)

Accounting choices. Gomez-Mejia et al. (2011) call the attention to earlier theories highlighting that family business owners have more benefit from tax aggressive behaviour than managers or shareholders of other firms. This is due to two reasons. (1) Due to their concentrated holding family owners get most of the benefit of any tax saving achieved, and (2) the direct influence of the family owners on the daily operation offer more opportunities for rent seeking. At the same time, family owners are more hit by a potential loss in the reputation of the firm (and thus their socioemotional wealth) and this effect seems to more than counterbalance possible benefits.

Family businesses are also less likely to manage earnings that is to artificially inflate profit or smooth earning across periods. In addition, audit firms are less likely to resign in family-owned companies that may hint to auditors receiving less pressure from owners. (See more on ethical challenges in Chapter 14.)

Research and development. Gama and Galvão (2012) emphasise that family businesses tend to be less innovative than other firms. Based on Gomez-Mejia et al. (2011) there are four reasons at least why R&D decisions may jeopardise the socioemotional wealth of the family and thus could decrease research activity level of family businesses below that of their counterparts. (1) R&D may require special knowledge not available within the family, and calling for outside experts to be hired. (2) R&D involves additional risk because of the likelihood of failures and losses. (3) R&D ideas often came for other production lines or activities, but family businesses tend to be less diversified. (4) R&D may require huge additional funding, but family firms are less willing to use external capital sources due to increased risk or loss of control. (See Chapter 7) A number of worldwide empirical results seem to support the idea of family businesses spending less on R&D than other companies.

## 2.4. Conclusion

This chapter reviewed Value Based Management (VBM) practices at family business. We highlighted that beside of eth monetary value we always have to consider the socioemotional wealth of the family when aiming at value maximisation. In family businesses, corporate governance systems have to deal with additional types of principal-agent problems due to intra-family conflicts. As seen, the key to keeping peace within the family could be adopting family governance practices (FGP) like organising family forums or preparing a family charter.

We have also experienced that selecting executives also has its specialities at family businesses. There are argument for and against involving several family members into the management and external executives are usually hired by also considering their fit into the family culture.

As for strategic decisions, family firms are more risk averse and long-term focused, care more for their stakeholders. These companies are usually less diversified and tend to acquire firms less often but with more success. Their preference for safety (and willingness to keep the family control) makes them to invest less into R&D, use lower leverage and outside financing, and they tend to adopt less radical accounting and tax policies.

## 2.5. Reflective Questions

1. Describe corporate governance specialities of family business. How to overcome those?
2. Why would you recommend having several family members involved into the management of a family business? What are some arguments against it?
3. What are the strategic advantages and disadvantages of a business being owned and controlled by a family?
4. What are the advantages and disadvantages of working in a family firm?

## UNIT 3: Financial reporting and analysis at family owned companies

Family businesses just like any other company provide information to their stakeholders by their financial reports. As these firms are usually of small size, many countries provide opportunity to publish simplified, less detailed statements only. In addition, in case of family business it is more likely that personal expenses of the owners are not perfectly separated from those of the company. Thus, we may face special challenges when analysing these statements.

Besides carrying information for the internal stakeholders of the company, the financial report represent the most essential source of decision making for the external users of funds. These agents comprehensively assess, which input parameters/data are required to estimate the credibility of the company. The factors determining creditworthiness vary according to the type of borrower concerned; in this regards, information based on the annual financial statements are completed by the information from the family businesses management. More specifically, the quantitative set of information (i.e. annual financial statements and customer data) are matched with qualitative ones (i.e. development and cyclical dependence of the market, special company risks, etc.). These are to be explained with more details in the second part of the chapter.

### 3.1. Financial Reporting for Family Businesses

Although the interest in family business research is growing rapidly, the area of financial decision making is underestimated. Motylska-Kuzma (2017) point out that despite of the fact that the vast majority of the studies into financial decisions in family firms is are focused on the capital structure, they do not give clear answers to the question of how the family businesses behave in this scope and what their true financial logic is.

Maintaining financial records and keeping records are essential to successful financial management of family businesses. In this context, the day-to-day financial activities made in relation to money management are necessary means for working towards long-term financial security (Capoor *et al*, 2004).

However, several obstacles can be recognised when financial planning is concerned. Family business owners does not have knowledge of accounting disciplines, such as management accounting and financial accounting. Accounting is one of the smallest area for family business owners do develop and they lack the understanding of accounting framework. The accounting financial analysis is vital for the family business in the 21st century. Family business needs to understand the role of accounting and various accounting practices exit within business world. The two fundamental practices that family businesses to familiarise their understanding is financial and managerial accounting. The fundamental practice which needs to be adopted by family business is the managerial accounting, it helps the family business to grow and control the daily costs. Salvato and



Moore (2010) argued that family businesses play a vital part in the economy, but they are not being recognised.

*Accounting practices in family firms, although displaying evident unique features, have received relatively little attention as distinct from their equivalents in publicly held firms. This may have hampered conceptual advancements in both the accounting and the family business literatures. (p.193)*

From a theoretical point of view, studies on accounting and reporting issues in family businesses have mostly adopted an agency theory perspective, probably due to the fact that agency theory has traditionally been the dominant framework in accounting research. Only a limited number of contributions have used alternative (or complementary) theories such as the stewardship theory, which give prominence to noneconomic factors that shape family firms management. (Prencipe *et al*, 2014)

The accounting is key for family business to understand the financial statements, ratio analysis and Accounting standards. The accounting and financial reporting provide overall analysis of the company and good indicator for family business to see how company has performed over the last 12 months. It also plays a vital role in managing business growth. Helps the family business to increase employees, develop new product or service and control costs. Lester (2016) stated that:

*Accurately tracking financial data is not only critical for running the day-to-day operations of your small business, but it is also essential when seeking funding from lenders or investors to take your business to the next level.*

Below are various key accounting practices that have been outlined for family business to follow.

### 3.1.1. Accounting Financial Statements

The accounting financial statements provide family business owners key information at the end of the year. The financial statements highlight the overall value of the business and summarise financial activities for specific periods. The family business owners can use financial statements to evaluate and judge the past and current financial state of their business. Therefore, it is important for family owners to understand and identify any existing financial complications. It is important for family business owners to understand the financial analysis and causes of the financial problems. To overcome the financial difficulties, the family business owners need to develop clear and effective knowledge of following financial documents.

### 3.1.2. Trial balance

The trial balance is a schedule which lists all the ledger accounts in the form of debit and credit balances to confirm that total debits equal total credits.

The balance sheet and trading and profit and loss account are prepared from a list of the various balances, which then produces a trial balance. Traditionally, the trial balance is



derived from the ledger accounts at the end of the financial year or accounting period. These accounts are drawn up by the owner or the accountant for the business. The business accountant records every single transaction that takes place in the business during the year.

In reality, the accountant or book-keeper for the family business or limited company will use a technique called double entry book-keeping with which to write up individual transactions in the ledger of accounts. The accountant needs to enter every transaction over the year twice in the books of annual accounts. This double entry process results in the forming of a trial balance for the business. In return, this equation balances both sides of the trial balance. Raj et al (2017, p.84) provided following outline for SME's.

Preparing a Trial Balance for Family Business encompasses the following tasks:

- Find the balance of each account on the ledger account.
- Businesses should record the ledger account balances in the right column of the trial balance.
- Once the ledger account balances have been recorded on the trial balance, then each column can be totalled up.
- Then both totals of the two columns of the trial balance are compared, to see if they match with each other or not.
- If the totals do not match, then the book-keeper or financial record keeper may have made a mistake in the ledger accounts.

This proof that debits and credits match the ledger accounts offers the business the opportunity to verify that the individual accounts are correct and accurate. It helps the accountant to prepare the final account with clear and effective proof that the accounting information is correct and efficient for the year. It is vital for businesses that the correct debit balances have been entered into the debit column and the credit balances are entered in the credit column of the trial balance.

The trial balance is used by the accountant to put together the final accounts. Businesses need to produce a working trial balance at the end of the year, usually using a layout such as the one shown in Table1.

Table 1. Example layout for a working trial balance of a Family Business

Trial balance for a Johnson as at 30 June 2017		
	<i>DR</i>	<i>CR</i>
Event income		
Sales		303,500
Capital		145,780
Event expenditure		
Purchase	93,800	
Motor expenses	7,800	
Office expenses	17,510	
Premises	100,500	
Motor vehicles	25,435	
Fixtures and fittings	18,645	
Light and heat	3,200	
Debtors	39,765	
General expenses	6,570	
Creditors		51,340
Bank	37,985	
Cash	7,890	
Drawings	13,400	
Stock at 1st Jan 2014	34,500	
Salaries and wages	67,950	
Rent and rates	25,670	
	500,620	500,620
Stock at 1st June 2017	31,200	

Source: Raj et al (2017, p.85)

### 3.1.3. The balance sheet

The balance sheet is one of the main financial documents used by any company, and provides information about its financial state. A balance sheet is a financial snapshot of the company's financial situation at any given moment in time. It is one of the financial statements that family businesses needs to produce to meet the legal requirement.

Essentially, a balance sheet is a list of the assets, liabilities and capital of a business. In addition, the purpose is to show the financial position of the business on a certain date during the year. Under the Companies Act 1985, 1989 and 2006 the balance sheet needs to be produced at the end of company's financial year. An example layout of a balance sheet for a sole trader is shown in Table 2.

Traditionally, a balance sheet is divided into two halves, the top half of the balance sheet shows where the money is currently being used in the business, and the bottom half of the balance sheet shows how the money has been raised by the business.

Table 2. Example layout of a balance sheet for a Family Business

Balance Sheet as at 30 June 2017			
Fixed assets			
		A	L & SE
Land and building		xxx	
Fixtures and fittings		xxx	
		xxxx	
Current assets			
Stocks		xxx	
Debtors		xxx	
Cash in hand		xxx	
		xxxx	
Current liabilities			
Creditors			xxx
Bank overdraft			xxx
Net current assets			xxxx
			xxxx
Long-term liabilities			
Long-term loan			xxx
			xxxx
Capital			
Capital as at 1 January			xxx
Profit for the year to 30 June 2017			xxx
			Xxxx

Adopted from Raj et al (2017, p.86)

### 3.1.4. Profit and loss account

The profit and loss account differs significantly from the balance sheet. The profit and loss account is a record of the family business trading activities over a period of time, whereas the balance sheet is the financial position at a given moment in time.

The purpose of the trading account is to measure the actual gross profit on trading of the business over the last twelve months. This is done by taking the total sales for the year minus the cost of sales (cost of goods sold). An example of a trading account is shown in Table 3.

Table 3. The trading account for a Family Business

		<i>DR</i>	<i>CR</i>
Sales			97800
Less Cost of Sales			
Opening Stock		12300	
add Purchases	43900		
less Discounts received	3450	40450	
		52750	
less Closing Stock		11,340	41,410
Gross profit			56,390

Source: Raj et al (2017, p.87)

The purpose of a profit and loss account is to define the gross profit of the business by deducting from it all the genuine expenses incurred in running the business over the last twelve months and arriving at a net profit for the given period. There are a number of different types of expenses that are incurred during the year in a business cycle, which are deductible from gross profit.

The profit and loss account looks at how well the firm has traded over the time period concerned (usually the last 6 months, or the last year). It shows how much the firm has earned from selling its product or service, and how much it has paid out in costs (production costs, salaries and so on). The net of these two is the amount of profit the business has earned. An example of a profit and loss account for a family business is shown in Table 4.

The basic principle of a profit and loss account is to show the net profit of the business for the financial year, that is, any money which is left after all relevant business expenses have been deducted from the gross profit.

Table 4. Example of a profit and loss account for a Family Business

		<i>DR</i>	<i>CR</i>
Gross profit			56,390
Less expenses			
Lighting and heating	1230		
add accrued electricity	189	1419	
Wages		11600	
Rent and rates	10200		
add rent owing	1200		
less rates prepaid	560	10840	
Telephone	355		
add accrued	35	390	
Insurance	980		
less prepaid	105	875	25124
Net profit			31,266

Source: Raj et al (2017, p.88)

Table 5. Example layout of a trading, profit and loss account for a Family Business for the end of a financial year

Trading, Profit and Loss Account for the year ended 30 June 2017			
		<i>DR</i>	<i>CR</i>
<i>Sales</i>			<i>xxx</i>
Less cost of sales			
Opening stock	<i>xxx</i>		
<i>Add purchases</i>	<i>xxx</i>		
<i>Less closing stock</i>		<i>xxx</i>	<i>xxx</i>
Gross profit			<i>xxx</i>
Less expenses			
Wages	<i>xxx</i>		
Rent and rates	<i>xxx</i>		
Telephone		<i>xxx</i>	
Insurance		<i>xxx</i>	
Total expenditure			<i>xxx</i>
Net profit			<i>xxx</i>

Adopted from Raj et al (2017, p.89)

As indicated in the profit and loss account, the expenses are those which have been incurred in the family business over the last 12 months. Table 5 shows an actual example of a trading, profit and loss account and balance sheet, for the year 2017.

### 3.2. Financial Report, serving as an outcome for the providers of external funds for Family Businesses

If your family-owned business is looking to obtain funding or capital, it helps to plan ahead based on the anticipated needs of the financial statement users (Steen-Neff, 2015). The main source of credit assessment data on family businesses is their annual financial statements, including their balance sheet and profit and loss statement. However, financial statement analyses are based solely on the past and therefore cannot fully depict a company's ability to meet future payment obligations. To supplement these analyses, cash flow forecasts can also be included in the assessment process. This requires a qualitative assessment of the company's future development and planning in order to assess how realistic these cash flow forecasts are.

Additional qualitative information to be assessed includes the management, the company's orientation toward specific customers and products in individual business areas, and the industry in which the company operates. The core objective of analysing these information categories should always be an appraisal of an enterprise's ability to meet its future payment obligations.

Depending on the nature and development of family businesses, the external providers of funds require different kind of information to assess the creditworthiness of a prospective borrower, with an analysis of the borrower's debt service capacity. In the case of start-ups for example, the information available will be very depending on the enterprises current stage of development and should be taken into account accordingly.

This analysis gives a simplified presentation of whether the borrower can meet the future payment obligations arising from a loan on the basis of income and expenses expected in the future. In this context, therefore, it is also necessary to assess the company's future development and planning in qualitative terms.

Table 6. Scope of information the external providers of funds might require for their assessment over the family business

		Corporate customers	Enterprises / Business Owners	Capital market-oriented / international companies	Other companies which prepare balance sheets	Enterprises not preparing balance sheets	Small businesses	Start-ups	Pre-launch stage	Post-launch stage	NPOs
Quantitative Data / Information	Based on past or present development	Annual financial statements			✓						
		Customer account management			✓						
		Income & expense accounts			✓	✓					
		Tax returns			✓	✓					
		Assets / liabilities (information from customer)			✓	✓					
		Equity/grant funding/financing needs							✓	✓	
		Collateral value of project assets (realization proceeds)									
		Collateral value of object financed (realization proceeds)									
		Fair market value of real estate									
		Rent levels for comparable properties at same location									
	Development of fair market value and rent levels (historical/expected)										
	Liquidity and revenue development									✓	
	Target/actual comparison of project progress										
	Target/actual comparison of cash flows										
	Target/actual comparison of construction progress										
	Credit stage / time to maturity										
	Credit card transactions										
	Purchasing behavior										
	Based on future development	Cash flow forecasts		✓							
		Debt service capacity			✓	✓			✓	✓	✓
Budget calculation						✓					
Expected sale proceeds (collateral value)											
Business areas (customers/products)				✓							
Risk structure / risk management											
Business policies											
Industry information				✓	✓	✓	✓		✓	✓	
Enterprise/management				✓	✓					✓	
Market (customers/products)				✓	✓				✓	✓	
Entrepreneur's personal traits				✓	✓			✓	✓		
Qualitative Data/ informationen	Based on past or present development	Type of project									
		Ownership structure / owners' creditworthiness									
		Liability relationships		✓	✓						
		Type of object									
		Type of commodity									
		Structure of financing transaction									
		Type of real estate									
		Socio-demographic data									
		Type and history of customer relationship to date									
		Information on living environment									
	Distribution channel										
	Purpose										
	Fulfillment of requirements										
	Occupancy rate										
	Further development of customer relationship										
	Payment reminder behavior										
	Payment behavior										
	Special agreements										
	General legal conditions (group ties)			✓	✓						
	Distribution of tasks at local government level										
Based on future development	Planning and future company development			✓	✓	✓			✓	✓	
	Business idea / business plan							✓	✓	✓	
	Stock price / price development			✓							
	Public relations/public information			✓							
	Current exchange price										
	Price development (historical/expected)										
	Country rating (sovereigns)										
	Form of government										
	General legal and political conditions									✓	
	Macroeconomic indicators										
External Data / Information	Capital market information	External rating		✓	✓						
		Infrastructure									
		Credit reporting information			✓	✓	✓		✓	✓	
		Creditworthiness of potential tenant(s)/lessee(s)/buyer(s)									
	Miscellaneous external information	Budget situation									

Source: OENB-FMA, 2004. p. 18.

### 3.3. Conclusion

Family firms have unique characteristics that explain why their accounting and accountability practices are different from those of non-family firms. These unique characteristics include the concentrated ownership in the hands of a controlling family, the power of the controlling family to pursue their goals, the involvement of the family in the governance of the firm, the interest of the controlling family in the long-term survival of the firm, the close relationship between managers and the family, and the relevance of noneconomic factors such as reputation, the emotional attachment of the family to the business (Carrera, 2017).

Besides its relevance for the management and owners of family businesses, the financial reports are carrying information for the financing decisions of the external providers of funds as well.

### 3.4. Reflective Questions

1. Critically evaluate the key issues addressed when family firms prepare reporting.
2. Explain and discuss the benefits of an organized system of financial records and documents. What suggestions would you give for creating an efficient system?
3. Explain why the main source of credit assessment data on family businesses is their annual financial statements.
4. Discuss for which reasons the qualitative data about the future development and prospects of family businesses are important to the external providers of funds.



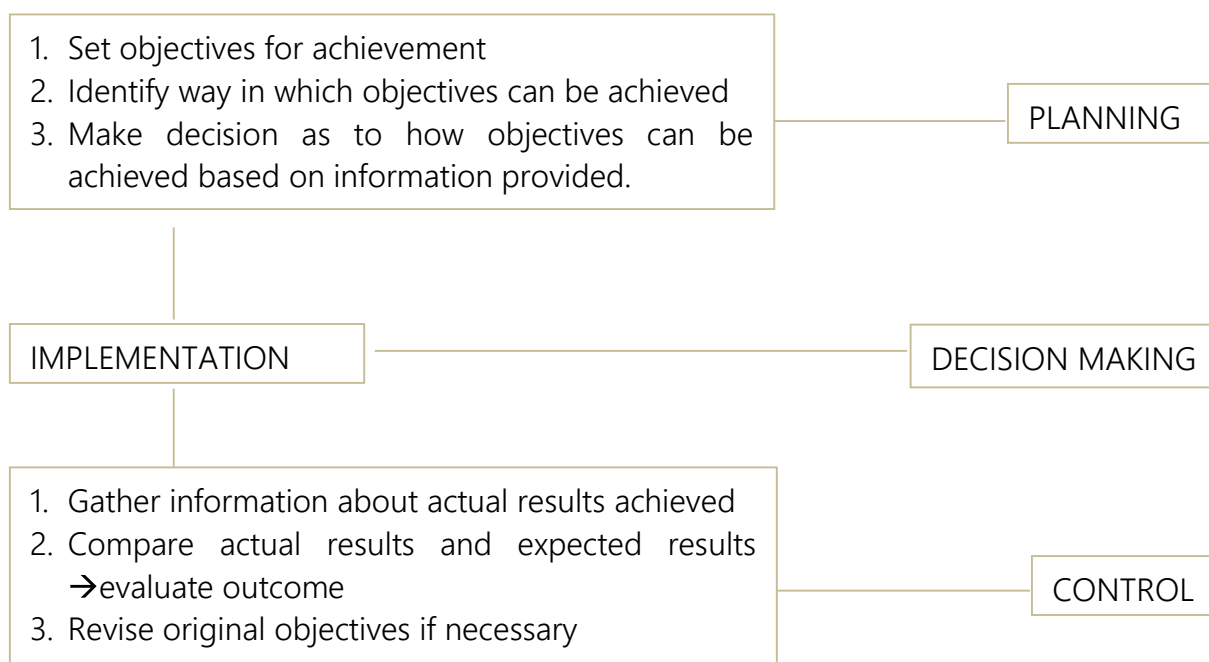
## UNIT 4: Financial planning and controlling

Financial reporting addresses the need for transparency and credibility of the firm's business standing. Gomez-Mejia *et al* (2013) argue that 'Family Control and Influence' and 'Family Identity' dimensions of socioemotional wealth serve as important reference points while making financial reporting decisions at family firms. In this sense, Family Control and Influence refers to the owner family's desire to maintain direct or indirect family control over the firm's strategic decisions, whilst Family Identity refers to the extent to which the family owners identify the firm with the family (in many cases, the firm itself becomes a projection of family and its core values).

### 4.1. Financial planning

In general to family firms, planning involves establishing the objectives of an organisation and formulating relevant strategies that can be used to achieve those objectives. In this regards, planning can be short-term (tactical planning) or long-term (strategic planning). (Prencipe *et al*, 2014)

Table 1. The managerial processes of planning, decision making and control



Source: Kaplan Financial Knowledge Bank, Management Accounting (2017)

As decision making involves considering information that has been provided and making an informed decision, in most situations decision making involves making a choice between two or more alternatives. Planning as satisfiability is a principal approach to planning with many eminent advantages (Huang *et al*, 2012). Further on during the

decision making process, managers use the information relating to actual results to take control measures and to re-assess and amend their original budgets or plans. After accomplishing this decision point, the next phase starts, which we call "concept evaluation". This phase evaluates the concepts according to the requirements and extracts the most suitable one. This step has to involve the customer as well. (Schmidt *et al*, 2015)

Here the company's management prepares a plan, which is put into action by the executives with control over the input resources (labour, money, materials, equipment etc.). Output from operations is measured and reported (feedback) to management, and actual results are compared against the plan in control reports. Managers take corrective action where appropriate, especially in the case of exceptionally bad or good performance. Feedback can also be used to revise plans or prepare the plan for the next period.

Concerning the implementation, responsibility centres, cost centres, profit centres, investment centres and/or revenue centres are distinguished within the company. The responsibility centre is an individual part of a business whose managers as personal responsibility for this performance.

The cost centre is a production or service location, function, activity or item of equipment whose costs are identified and recorded. (For example, for a paint manufacturer cost centre might be: mixing, packing department, administration or selling and marketing department; whilst, for an accountancy firm: audit, taxation, accountancy, word processing, administration, canteen can be a cost centre.) The cost centre managers need to have information about costs that are incurred and charged to their cost centres. The performance of a cost centre manager is judged on the extent to which cost targets have been achieved.

The profit centre is a part of the business which both the costs incurred and the revenues earned are identified. These kind of profit centres are often found in large organisations with divisions, and each division is treated as a profit centre. However, within each profit centre there could be several costs centres and revenue centres. In this regards the performance of the profit manager is measured in the terms of the profit made by the centre; the manager must therefore be responsible for both costs and revenues and in a position to plan and control both. The data and information relating to both costs and revenues must be collected and allocated to the relevant profit centres.

Regarding the investment centres, managers are responsible for investment decisions as well as decisions affecting costs and revenues, they are therefore accountable for the performance of capital employed as well as profits (costs and revenues). The performance of investment centres is measured in terms of the profit earned relative to the capital invested (employed). This is known as:  $ROCE = \text{Net profit} / \text{Capital employed}$

Revenue centres represent a part of the organisation that earns sales revenue. They are similar to a cost centre, but only accountable for revenues, and not costs. Revenue centres are generally associated with selling activities, for example regional sales managers may have responsibility for the regional sales revenues generated; and each regional manager would probably have sales targets to reach and would be held responsible for reaching these targets. The sales revenues earned must be able to be tracked back to individual (regional) revenue centres so that the performance of individual revenue centre managers can be assessed.

#### 4.2. Controlling and monitoring financial resources

The relevant literature (see for example Basco, 2015) emphasises the family business' unique bundle of resources, as the presence of family members alters organizational objectives and incentives and thus affects firm decision making, and consequently influences how family firms interact economically and socially with their environment.

Company growth and development depend not only on the stock of capital and production factors but also on who owns and works with them. Specifically, family ownership and the management regime alter how an organization is governed and managed because decisions are made in a specific organizational and productive framework (Jaskiewicz and Luchak, 2013). This framework emerges from the contrast of family logic and business logic with different types of member affiliation (i.e., birth versus qualification), aims (i.e., family-oriented goals versus business-oriented goals), legitimacy (welfare versus rational myth), and dominance (i. e., traditions versus rational views) (Pérez Rodríguez and Basco, 2011). Consequently, decision making differs between family firms and non-family firms in areas such as equity financing, corporate diversification, level of debt, innovation, risk, internationalization, and general and specific management practices, among others. Therefore, if decision making is affected by the type of ownership and management regime, then ownership and management regime may have an effect at the firm level, such as on firm performance and efficiency in the use of production factors (Basco, 2014, Stafford *et al*, 2013, Haynes *et al*, 1999).

In the context of the above complex management decisions frame, information, details are needed for each cost, profit, investment and revenue centre. Such information is provided by cost accounting and management accounting systems, as explained below. Cost accounting is a system for recording data and producing information about costs for the products produced by an organisation and/or the services it provides. It is also used to establish costs for particular activities or responsibility centres. Cost accounting involves a careful evaluation of the resources used within the enterprise. The techniques employed are designed to provide financial information about the performance of the enterprise and possibly the direction that future operations should take.

Management accounting has cost accounting at its essential foundation. However, the main differences between management accounting and cost accounting is the following:

whilst cost accounting is mainly concerned with establishing the historical cost of a product/service, management accounting is concerned with historical information but it is also forward-looking. The latter is concerned with both historical and future costs of product/service (e.g. budgets and forecasts), and is also concerned with providing non-financial information to managers. It is essentially concerned with offering advice to management based upon information collected (management information), and consequently it may include involvement in planning, decision making and control.

Table 2. Differences between management accounting and financial accounting

	Management accounting	Financial accounting
Information mainly produced for	Internal use: e.g. managers and employees	External use: e.g. shareholders, creditors, lenders, banks, government
Purpose of information	To aid planning, controlling and decision making	To record the financial performance in a period and the financial position at the end of that period
Legal requirements	None	Limited companies must produce financial accounts
Formats	Management decide on the information they require and the most useful way of presenting it	Format and content of financial accounts intending to give a true and fair view should follow accounting standards and company law
Nature of information	Financial and non-financial	Mostly financial
Time period	Historical and forward looking	Mainly historical record

Source: Kaplan Financial Knowledge Bank, Management Accounting (2017)

### 4.3. Conclusion

By management accounting practices we refer to tools such as product costing, budgets for planning and control, standard costing variance analysis among others. Studies examining the role of managerial accounting in family firms have also shown that management accounting practices can influence significantly the transfer of knowledge across generations as well as between the management team and the family (Giovannoni et al. 2011); however, such influence depends on the size of the company.

### 4.4. Reflective Questions

1. Explain and discuss the nature and scope of information provided as an outcome by (i) financial accounting and (ii) management accounting.
2. In which aspects do you think decision making differs between family firms and non-family firms in financing, innovation, risk, etc.?
3. How would you design an optimal workflow of planning within a family firm?

## UNIT5: Operational management and investment policy

Managing a firm could be quite a challenge particularly for those without a formal training in organisation, leadership, or management. At the same time, based on the papers covered in this chapter issues like supply chain management, culture, or quality of information and IT systems could have a massive effect on the value of a family business. The same is true for investment decisions that have their own special characteristics in case of family firms. No wonder that the employment of a professional management adds great value for these businesses.

### 5.1. Managing your operation

What drives the utilisation of modern financial tools in the everyday management of family businesses? Di Giuli, Caselli, and Gatti (2011) instigated the financial sophistication of the family businesses. Based on the data from 187 Italian small businesses owned dominantly by a single family for the years 200-2002, they concluded that financial sophistication is linked to (1) the owning generation, (2) employment of external CFO, and (3) the existence of external shareholders. Based on their results, the toolkit of corporate finance (appearance of MBO, LBO, M&A and debt restructuring advisory) and cash management is more complex if a firm is owned by the third or later generations compared to those companies in hand of earlier generations. Employment of an external CFO had positive effect on cash management only, while the existence of external shareholder enhanced both the risk management (use of derivatives) and the use of advanced corporate lending products (factoring, leasing, commercial papers, and syndicated loans). Employing an external CEO was not connected to any of the financial fields examined.

Concerning the working capital management techniques used, Filbeck and Lee (2000) found that more than half of the US family businesses did never use most of the tools listed in their survey. Still, they found significant difference considering the working capital management techniques applied by small and big family firms. While smaller firms tended to use less of the most modern methods, we can not clearly say they would be lagging behind, as bigger companies used very basic methods also more frequently. (Table 1) Larger firms were more likely to perform account receivable and accounts payable analysis than smaller ones, most like because managers of smaller companies may keep a better overview for a smaller number of partners. As for the generation effect, they conclude that firms in hands of later generations tend to use modern techniques more often, but the use of older techniques is just as common as in case of younger generation controlling the business.

Table 1 Use of Working Capital Management Methods

Method	Frequency	Small firms*	Large firms**
Cash Budgeting Projections	Frequently	59.3%	53.3%
	Rarely	11.1%	16.7%
	Never	29.6%	0.0%
Breakeven Analysis	Frequently	48.1%	53.3%
	Rarely	18.5%	40.0%
	Never	33.4%	6.7%
Sales Forecasting	Frequently	40.7%	82.8%
	Rarely	18.5%	10.3%
	Never	40.8%	6.9%
Cash Management Models	Frequently	29.6%	53.6%
	Rarely	11.1%	32.1%
	Never	59.3%	14.3%
Security Portfolio Models	Frequently	0.0%	11.1%
	Rarely	11.1%	14.8%
	Never	88.9%	74.1%
A/R and Credit Analysis	Frequently	29.6%	58.6%
	Rarely	14.8%	27.6%
	Never	55.6%	13.8%
Inventory Control Methods	Frequently	18.5%	44.5%
	Rarely	14.8%	33.3%
	Never	66.7%	22.2%

\*Sales below 10 million USD \*\*Sales above 10 million USD

Source: Based on Filbeck and Lee (2000, p. 207)

The daily operation of the family businesses is also unique in some aspects. Larraz, Gené, and Pulido (2017) analysed a sample of over 8600 medium and large Spanish firms for the period 2008-2013 and learned that family firms use less capital-intensive technologies and pay on average a lower wage than non-family companies. In addition, productivity of family businesses is lower, and they spend a bigger percentage of the added value on self-financing and use less of it on dividend payment than their counterparts.

The cash management of family firms also shows distinctive traits. Ozkan and Ozkan (2004) showed that family owned public UK firms held significantly more cash and marketable securities than other companies during the period 1984-1999.

An explanation to this is given by Lozano (2015) who highlights that family businesses are able to optimise their cash holdings better than other companies. Regarding the cash holding motives beside of the classic liquidity (transaction), precautionary (staying safe) and speculative (waiting for better investment opportunities) motives, she also lists some unique drivers.

Among those (1) conservatism (higher risk averseness) calls for higher cash reserves, and the same is caused by the fact that families also often see cash accumulation with the firm

as a way (2) to evade corporate and personal tax on the profit that would otherwise increase their personal savings. Also, the (3) shortage of external financing (families usually wish to keep control over the firm and dislike bank loans, see Chapter 5) lead to cash accumulated from own earnings being the main and sometimes only source of covering investment expenses. As most family businesses employ a family CEO, the (4) management-shareholder agency conflict is not apparent (see Chapter 3), reducing cash reserves within the company loses its main motive. Of course remaining types of agency problems (e.g. between active-passive shareholders) may still push owners to redraw cash.

Steijvers and Niskanen (2013) found that the relative amount of cash holdings are linked to management characteristics. Based on their sample of nearly 2600 nonfarm, nonfinancial US firms with less than 500 employees, descendant CEOs tend to maintain higher cash reserves than founder CEOs, particularly if there is a low dispersion of ownership. In line with the agency theory predicting lower efficiency, companies with outside CEOs tend to have more cash holding than family CEOs if the business had only one single owner.

The working capital itself is strongly linked to the supply chain that the company is part of. Maloni, Hiatt, and Astrachan (2017) highlight the financial importance of well-established supply chain management (SCM) within family businesses. Jayaram, Dixit, and Motwani (2014) describe the SCM at family SMEs in India. Based on case studies on six manufacturing firms, they concluded that inventory management is vital from financial point of view as 22 percent of total yearly industry sales is tied up in inventory across the supply chain. They underline that professionally managed firms take more care of the SCM by developing their information technology (IT) and information systems (IS), what leads to cost savings and higher utilisation level. This result shows that not only the employment of an external CFO may add value.

Tan, Bi, and Smyrnios (2014) focused on data of 1335 Australian fast-growth family SMEs from 2002 to 2009 and concluded that better supply chain management also increases the business value there. They particularly emphasise the importance of customer and competitor orientation that if being part of the organisational culture can foster the sales performance and thus the financial success.

## 5.2. Investment activity at family businesses

Finding investment opportunities fitting into the strategy and choosing among them is difficult for any firm. In case of family businesses, though, the complexity of this task is even higher. In case of investment decision of family firms, two contradictory effects may be identified. (Asaba, 2013) (1) The high level of family ownership tends to make firms for risk averse, while (2) the high level of managerial ownership should generally increase the willingness to invest.

On one hand, family businesses tend to be more long-term focused, pushing for stable investment even under volatile and stagnant environment. (Asaba, 2013) On the other



hand, when considering investment alternatives, family businesses tend to be more risk averse than other companies leading to find less adequate opportunities. (Zellweger, 2017, Chapter 9) This is because owners are less diversified both concerning economic and socioemotional wealth than other stockholders and the family shareholders usually have a very strong direct influence on the operation and particularly on the investment decisions of their business, decisions are more cautious.

The low level of diversification of the owners' personal portfolio would call for a diversification within the company. However, as we have seen in Chapter 3, a diversification strategy may need special expertise not available in the family, additional external financing, and more professionalised organisation. For to provide these, current owners may have to face a number of intra-family conflicts and sacrifice some of their control over the firm. These challenges may hinder diversification intentions considerably. Thus, investment decisions could be restricted to replacement decisions or doing more of the usual projects, not needing to much of financial knowledge.

A big step forward could be to hire a professional CFO, who would call the attention of family members to these problems. (Steps of this process were presented in Chapter 3.) Based on interviews with top managers of over 100 Australian family SMEs, Gurd and Thomas (2012) concluded that, contrary to expectations, family CEOs work well together with external CFOs, and the financial top managers stated that the strong family commitment to the future of the business eases their work. (The most important tasks of the CFOs within a family business is shown on Figure 1.) Interestingly, they do not have conflicts with external accountants either as those usually question personal financial practices of the family members and the tax aggressiveness of the company, while CFOs focus on the financial management of the business.

Based on their results, the position of the non-family CFO within a family business seems to be affected by four factors. Those were (1) CEO's openness to communicate with non-family managers, (2) CEO's awareness of her/his own level of financial knowledge, (3) perceived level of support received from family members, and (4) the commitment of the family to the business.

At the same time based on the principal-agent theorem, high managerial ownership should lead to higher investment activity as information asymmetry is far lower than otherwise. When analysing the listed firms in Japanese electric machinery industry over the years 1995 to 2006, Asaba (2013) found evidence for both of these effects (family ownership, managerial ownership) to play an important role in the investment process of family firms. He found that family firms tend to invest more than their non-family counterparts do. When investment opportunities are good, this could be explained by the reduced agency costs. Nevertheless, this additional investment effect was present also while investment opportunities were poor (agency theory would propose the opposite) that could be due to the long-term focus of the owning family. This means that the more



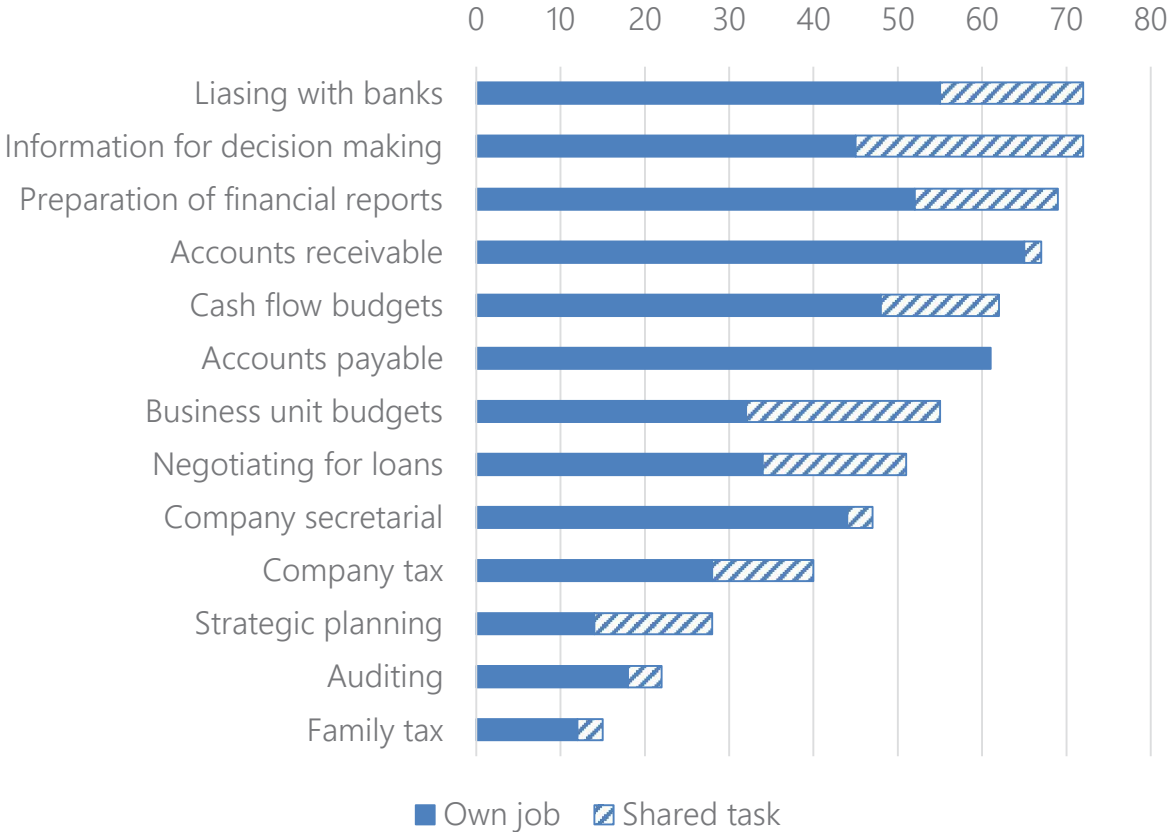
pronounced long-term focus of the family businesses more than counterbalances the effect of their higher risk aversion regarding investments.

Connelly (2016) investigated publicly traded, non-financial companies from Thailand for the period 2001 to 2010 and showed that lower proportion of family ownership leads to less than average investment, while higher proportion (i.e. less information asymmetry), and particularly pyramidal ownership tends to go hand in hand with higher investment activity. As growth opportunities increase, the gap between these two groups narrows. In addition bigger firms tend to invest proportionally more than smaller ones. He also concluded that investment activity of firms with higher family ownership show greater sensitivity to financing constraints.

However, it seems that this higher-than-average investment is not typical in all regions for all family firms. For example, Lin, Wang, and Pan (2016) concluded based on data from 1996 to 2011 that listed family businesses in Taiwan were more likely to under-invest than other companies.

Similarly, based on data for the top 2000 US firms (excluding the financial industry and regulated public utilities) from 2003 through 2007, Anderson, Duru, and Reeb (2012) concluded that family firms spend less on investment than firms with diffuse ownership structures. They also highlighted that family firms prefer investing into physical assets rather than to riskier R&D. Family businesses seem to be less efficient in R&D anyway as they receive less patent citations per dollar relative to nonfamily firms.

Figure 1 Most important tasks of CFOs in family businesses (percent, SMEs, Australia)



Source: Based on Gurd and Thomas (2012, p. 293)

Based on data from almost 8500 Italian private manufacturing firms with at least 50 employees from the years 1996 to 2007, Magda et al. (2013) and concluded that family firm investments are more sensitive to uncertainty than those of the non-family companies are. In their interpretation, the main reason for this difference is that family owners perceive investments irreversible probably because of the higher illiquidity of holdings in a family firm.

Kotlar et al. (2014) offer a deeper understanding of factors explaining the seemingly contradicting results. They examined the strategic reference points of Spanish manufacturing firms over the period 2000-2006. They concluded that family firms do not react to changes in different reference values the same way as nonfamily firms do. While family businesses usually take less risk and tend to react to changes less radically (measured by change in R&D investments) when choosing their strategy than other firms do, in case the market power of the buyers or the suppliers increases radically family-owned companies tend to opt for even riskier strategies than other entities would. Also, when resource availability is high, family firms take similar amount of risk as other companies do.

Baronchelli et al. (2016) call the attention to another explanatory factor, the age of the business. Based on a sample of 112 Italian SMEs they showed that for younger firms (less than 16 years) family ownership tends to be associated with less foreign direct investment

in psychically distant countries (in the Far East) (higher strategic risk), while for older firms (over 44 years) family ownership seems to slightly increase the number of those investments.

Table 2 Use of Capital Budgeting Methods

Method	Frequency	Small firms*	Large firms**
Net Present Value	Frequently	22.2%	29.6%
	Rarely	3.7%	44.5%
	Never	74.1%	25.9%
Internal Rate of Return	Frequently	11.1%	38.5%
	Rarely	7.4%	38.5%
	Never	81.5%	23.0%
Payback Method	Frequently	22.2%	74.1%
	Rarely	14.8%	22.2%
	Never	63.0%	3.7%
Accounting Rate of Return	Frequently	7.4%	30.8%
	Rarely	14.8%	53.9%
	Never	72.8%	15.3%

\*Sales below 10 million USD \*\*Sales above 10 million USD

Source: Based on Filbeck and Lee (2000, p. 207)

As for the budgeting process itself, based on a survey of 61 US family businesses, Filbeck and Lee (2000) found that smaller firms tend to use Internal rate of return (IRR) significantly less often than large companies, but the frequency of usage of the most popular budgeting method, NPV was similar for both groups. (Table 2) At the same time, the age of business did not show any connection with the techniques used.

When contrasting results with earlier papers, they underline that while generally 90 percent of US firms use either NPV or IRR in their budgeting decisions, only 28 percent of the family firms reported using those. Half of the family owned companies never use these theoretically far better methods.

They showed that firms without outside influence (at least one external board member, and a non-family member primary financial decision maker) use less advanced techniques (payback period, average accounting rate of return) more often. This finding underlines the added value coming from the knowledge of external decision makers.

### 5.3. Conclusion

The daily operation of financial businesses raises several financial challenges. In addition to the factors considered at other firms, family companies care about socioemotional wealth (e.g. personal connections in the supply chain), to keep control over the firm, owners prefer to use less capital intensive technologies, and hold bigger cash reserves. But the family firms themselves do not form a homogenous group. The generation owning the business, the presence of external decision makers (not only in the field of finance but also in IT, purchasing, logistics, sales) and non-family shareholders, the organisational culture, and the size of the business seem to have a considerable effect on the financial sophistication of the given company.

When deciding about investments, long-term focus, increased risk aversion, lower liquidity of the shares, and the availability of special financial knowledge (external CFO) all influence the process. While due to increased risk aversion, family ownership may reduce the amount of investment, family-member decision makers reduce the agency effect that generally leads to more investment. Thus, as we have also seen, the same change in reference points (macro conditions, market power of business partners and competitors) may lead to very different changes in strategy for a family and a non-family business. It is even possible, that it is the family firm that opts for a more risky strategy in a given situation. When examining the family firms only, age, size, ruling generation, and the appearance of external decision makers could explain the differences in the budgeting process among them.

### 5.4. Reflective Questions

1. What are the unique traits of family businesses in daily operation management?
2. What budgeting techniques do family firms prefer in your country? Why?
3. What factors could explain differences among family businesses?
4. How would you enhance efficiency of family companies as an owner, as a CEO, and as a member of the national government?

## UNIT6: Financing a family business

Introducing different sources of funds to the operation of family businesses is unavoidable, and – with clever design – is beneficial. Vadnjal & Glas (2008) argue that family businesses need to understand that insisting on the self-sufficient manner of financing their business may result in limited possibilities of growth and further extension of their operation which would be necessary for setting a solid ground for successful transition of family businesses on to the next generation.

There are preconditions for raising external sources of funds, as the profit generating capability of the firms. Fama and French (2005) point out that the profitability and growth characteristics of firms are central to their financing decisions, since valuable growth opportunities indicate how much investment a firm may need and profitability reflects to what extent these investment needs can be funded internally. However, whilst it is important to keep company's cash flow healthy on one hand, signing a bad financing agreement can hamper the business growth for years to come on the other. From this point, it is necessary to overview the forms and main characteristics of financing to enterprises.

This chapter starts with the financial instruments as investment assets of a company; then turns to the forms of financing to a company.

### 6.1. Investment asset types

Financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. The entity that subscribes to the shares has a financial asset – an investment – while the issuer of the shares who raised finance has to account for an equity instrument – equity share capital.

This distinction is so important as it will directly affect the calculation of the gearing ratio, a key measure that the users of the financial statements use to assess the financial risk of the entity. The distinction will also impact on the measurement of profit as the finance costs associated with financial liabilities will be charged to the statement of profit or loss, thus reducing the reported profit of the entity, while the dividends paid on equity shares are an appropriation of profit rather than an expense.

When raising finance the instrument issued will be a financial liability, as opposed to being an equity instrument, where it contains an obligation to repay. Thus, the issue of a bond (debenture) creates a financial liability as the monies received will have to be repaid, while the issue of ordinary shares will create an equity instrument.

It is possible that a single instrument is issued that contains both debt and equity elements. An example of this is a convertible bond – ie where the bond contains an

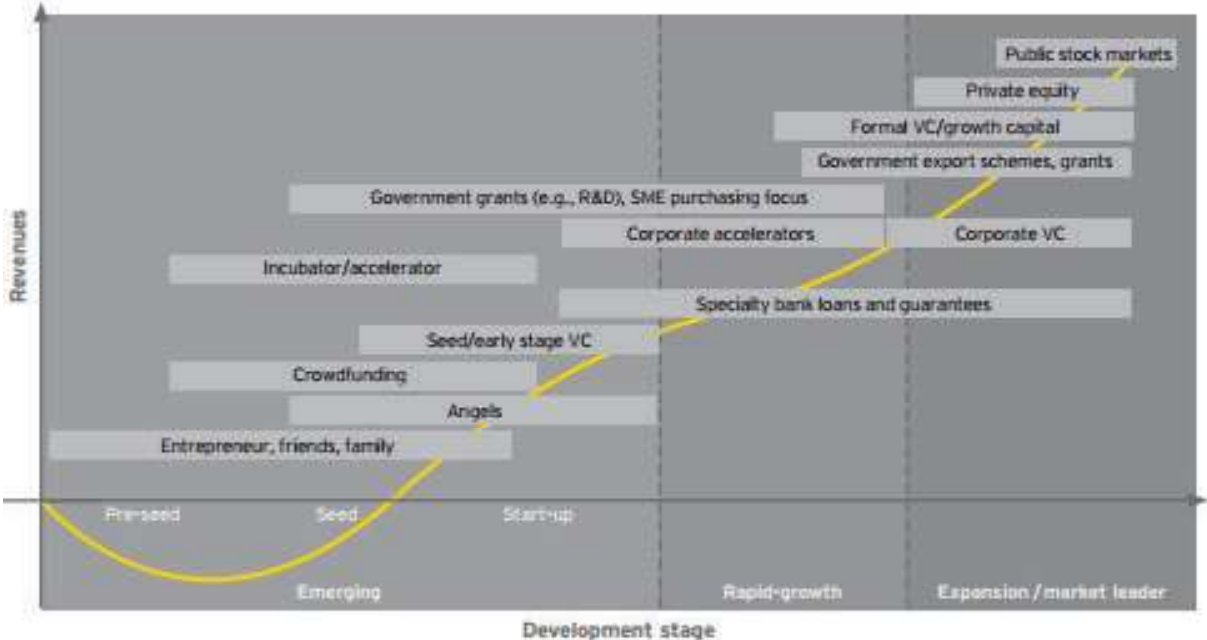
embedded derivative in the form of an option to convert to shares rather than be repaid in cash.

Accounting for a financial liability at amortised cost means that the liability's effective rate of interest is charged as a finance cost to the statement of profit or loss (not the interest paid in cash) and changes in market rates of interest are ignored – i.e the liability is not revalued at the reporting date.

6.2. Sources of capital

As a family business is growing by turnover, number of employees, is becoming more structured by operation, and is generating more profit cash through its years, more and more sources of funds are becoming available. Start-up businesses rarely have the pleasure and luxury of sufficient funds to sustain their current and planned business expenditure. However, they need to obtain sufficient funds in order to compete within the industry, and must therefore look to external sources of finance to meet their business obligations. In their start-up phase, family businesses usually earn insufficient profit and cash flow, and are lacking assets to be placed as collaterals. Stable profit and cash flow generating capability only occurs when the company entered into the growing and maturing phase. Graph 1 shows the scope of funds, available as the business earns increasing amount of revenues and profits.

Graph 1. Access to sources of funds



Source: Damodaran (2015), p. 13

### 6.2.1. Venture and equity capital

The private equity and venture capital companies are ready to invest to a company at any time of its lifecycle, but usually the certain funds specializes to beginner and matured companies. At this point it is needed to make a distinction between the private equity and venture capital.

Private Equity provides capital to companies not quoted in the stock exchange. Usually this type of source is used to finance the development of products, introduction of technologies, expansion of current assets, acquisitions or to stabilize the company's balance sheet. This type of investment usually modifies the ownership – and eventually the leadership - of the company and it can be used in case of succession also. Private equity investors enter to the market in the case of more developed companies and usually invest in higher amounts. Mostly the buyout and turnaround type transactions are represented by them.

Venture Capital is also a professional form of investment, but funds companies in early stages like seed, start-up and later stage venture. As in case of early stage phases, the risk is higher than average, the investors expect higher returns also.

The types of the capital investment:

Early stage (Venture capital)

- Seed capital (evolving of the business concept, preparing of the business plan, financing of Research and Development or prototypes before the start)
- Start up (product development, market research, in case of birth or operation of companies)

Later stage (Private equity)

- Growth capital (financing of expansion, acquisition of a company)
- Turnaround (acquiring of a matured company to restructure and reorganize)
- Buy-out (acquisition of a company or a business line – Management BuyOut (MBO), Management BuyIn (MBI), Institutional BuyOut (IBO), Leverage BuyOut (LBO))

Exit means that an investor would like to sell its investment in the company, which can be executed by MBO, involvement of another investor or the Initial Public Offering (IPO), the first sale of stock by a private company to the public.

### 6.2.2. Family loans

Personal debt for financing a business

Many entrepreneurs begin their enterprises by borrowing money from friends and relatives. Such individuals are more likely to provide flexible terms of repayment than banks or other lenders and may be more willing to invest in an unproven business idea, based upon their personal knowledge and relationship with the entrepreneur.

A potential disadvantage is that friends and relatives may try to become involved in the management of the business. Business owners who wish to avoid such complications must use the same formal arrangements with relatives and friends as with more distant business associates. But It is not work always in practice.

Founding a business is extremely risky. Therefore it is hard to raise sufficient capital to found a firm. Costs of founding includes legal costs (lawyer, company register etc.), shareholder's capital and so on. If founders do not have enough money to cover all the costs but they are committed to found the firm they should get somehow the missing cash amount. Traditionally we say that there are four sources to get it:

- family
- friends
- fools

Regarding the founders themselves, the four sources are called 4F. In that context fools means people or organisations which takes the risk of a new business and its potential default. That risk is enormous, the most new businesses do not live 2-4 years and do not earn profit as well. But in some cases, if the idea is good enough and business starts growing, return can be high.

A new hype in fundraising is the crowdfunding. Crowdfunding is an online hub, where individuals from all around the world can donate or aid a project. Spite of most individual pays a relative low amount of money, say 5-10 euro, due to the high number of participating individuals, necessary capital of the project can be gathered in some months. In return for support, individuals get a specific advantage, which depends on the project owners. Donors, who pay say 5-10 euros get the experience to help a project but those who pays 20-25 euros, get a basic edition of the product and those, who pays 50 euros get a dedicated or a premium edition.

Others use crowdfunding to finance their own personal needs. In that aspect crowdfunding means a crowdfunded loan, where the borrowed money comes from a number of different people. In that case borrower pays interest as well.

In case of an existing business owners can use much more sources of funding. Such source is the retained earnings or bank loans. The most author says that sources of funding have different "popularity" among companies. For example, large listed companies prefer bond financing to issuing shares. The pecking-order-theory explains the expected ranking of sources. In case of family businesses the ranking as follows:

- company profits,
- loans from family,
- loans from banks and others,
- equity of owners,
- equity of new family members,
- and equity of new external investors



Authors suggests that family businesses do not use foreign capital or debt, because using them can deteriorate their independence. Papers indicate, that in most European countries family firms forgo growth opportunities due to a lack of internally generated funds and own equity.

### 6.2.3. Bank loans

Borrowing money from the bank is the traditional method used by businesses to raise funds for their current and future projects. Interest must normally be paid on any money borrowed from the bank. There are different forms of bank loan which are available to businesses. It is generally more difficult for new businesses to secure cheaper rates of interest; these are usually only offered to reputable businesses with good track records. The business will need to repay the bank loan in regular instalments, with interest rates being set according to the official central bank rate.

There is an endless range of loans on offer, to suit all types of businesses. These vary according to:

- the amount required by the business;
- the length of time over which the business will repay the loan;
- the type of interest rate being charged by the bank (e.g. fixed or variable).

Choosing the right type of interest rate is very important for the business in the long run. This can be difficult, since both fixed and variable rates have advantages and disadvantages. For example, taking out a fixed rate loan means that the company can accurately predict the size of the monthly repayments. On the other hand, repayments on a variable rate loan can fluctuate if the base rate changes in line with the official central bank rate. In addition, the banks charge individual customer's different rates, usually ranging between 3 per cent and 4.5 per cent on top of the official central bank rate.

### 6.2.4. Overdrafts

An overdraft is the most common form of debt available to businesses in the short term. An overdraft is easy to arrange and does not have a minimum borrowing term. It is a flexible method to use in order to finance a business shortfall over a short period. The money can be drawn down by the business fairly quickly and repaid over the period agreed with the bank manager; though interest rates and ease of borrowing will depend on the state of the business and on the history of the company. If a company has no previous track record, banks will require some form of security, perhaps involving the assets of the business or the personal property of the owner. Where a business uses its assets to secure an overdraft, this clearly limits its ability to sell these assets or to use them to secure any other sources of finance. However, if the business has a good track record, an unsecured overdraft facility is easy to arrange. One of the main advantages of this type of borrowing is that the debt can be paid off at any time without incurring a penalty. On the other hand, an overdraft is repayable on demand from the bank. Since overdrafts are given and the interest rate set according to the status of the individual account, new customers are normally charged more than long-standing customers.

### 6.2.5. Bonds

Corporate bonds are immaterialised financial instruments. Similar to loans and other debt instruments (for example bill of exchange or commercial loans) corporate bonds are external source of finance. Accordingly, corporate bonds play quite same role in the business. Most characteristic similarities are as follows:

- interest is tax deductible;
- rates of interest and dates of interest payments and capital repayment(s) are clearly stated;
- investor's major risks are related to the insolvency of the firm (repayments of interest and/or capital). In case of default on interest and/or capital payments investors have same rights as banks, such as seize the assets pledged and sell them, in order to obtain owed amount.

On contrary to bank or other loans, in case of bond financing firms get money directly from capital market. That means that the firm does not borrow money from a particular institution or person but from a group of investors who can then trade bonds as well. Bonds are traded in most cases on stock exchange or OTC markets.

In the United States a much larger proportion of firms use capital market to finance their operations but in the continental Europe it is typical only for bigger companies. Therefore, bond financing is nearly irrelevant for family firms.

In order to reduce information asymmetry between firm and investors firms and thus the bond's risk premium firms can order credit rating for their bond. Credit rating is a standard and well communicable scale of a rating agency and shows the expected probability default on payments. The most known rating agencies are Standard & Poor's, Moody's and Fitch, all of them from the United States. They use both published and unpublished information, such as financial statements, news, industrial trends in order to make a proper rating. To improve the rating process, the previous ratings are compared with actual information, thus rating process is continually developed. It is important to state, that ratings are ex-ante assumptions which are made on a base of a standard (but permanently developing) methodology.

Table 1 Credit rating of the biggest rating agencies

Standard & Poor's	Moody's	Fitch IBCA
AAA	Aaa	AAA
AA+	Aa1	AA+
AA	Aa2	AA
AA-	Aa3	AA-
A+	A1	A+
A	A2	A
A-	A3	A-
BBB+	Baa1	BBB+
BBB	Baa2	BBB
BBB-	Baa3	BBB-
BB+	Ba1	BB+
BB	Ba2	BB
BB-	Ba3	BB-
B+	B1	B+
B	B2	B
B-	B3	B-
CCC+	Caa1	CCC+
CCC	Caa2	CCC
CCC-	Caa3	CCC-
CC	Ca	CC
C	C	C
D	n/a	D

Source: BIS Long-term Rating Scales Comparison  
<https://www.bis.org/bcbs/qis/qisrating.htm>

We can distinguish between high quality (investment grade) and so called junk bonds. The differentiation is the most typical in the United States, where investors are likely to buy junk bonds, because increased risk level is compensated with higher yield. On the contrary, in Europe conservative investors buy bonds (low risk, low yield), while investors with higher risk appetite buy usually shares (high risk, high yield).

Bonds can be classified based on several characteristics. The most important types of bonds are follows.

- Interest rate: fixed rate, variable rate (rate changes in a predetermined manner), floating rate (rate linked to a base rate like LIBOR)
- Interest payment: none (zero coupon), regular (semi-annual, annual), accumulated interest payment at maturity (bullet)
- Principal payment: regular equal instalments, bullet payment (at maturity), annuity bond (interest and principal payment made regularly totalling each time to the same amount)

- Attached option type: none (conventional bond), puttable (holder may sell back to issuer under pre-set condition), callable (issuer may repurchase under pre-set conditions), convertible (owner has the right to convert bond to common share at a given price and at a specified date)

Theoretical price of a bond defines a price determined on an efficient market. The theoretical value of an asset is calculated as the sum of present value of future cash flows (interests and principal payments).

Consider a conventional bond, its face value is 100€ and pays an interest of 10% per annum. That bond matures exactly in 5 years. Let's assume that yield curve is constant at 5%. According to these information, real value of that bond is calculated as follows:

Table 2 Sample for calculating a bond's real value

period (years)	1	2	3	4	5
Interest	10	10	10	10	10
Principal	0	0	0	0	100
Total	10	10	10	10	10
Discount factor	$\frac{1}{(1 + 0.05)}$	$\frac{1}{(1 + 0.05)^2}$	$\frac{1}{(1 + 0.05)^3}$	$\frac{1}{(1 + 0.05)^4}$	$\frac{1}{(1 + 0.05)^5}$
Present value	9.5	9.1	8.6	8.2	86.2

The sum of present values of future payments is 121.6€ which is the real value of our abovementioned bond. As the price of a bond is usually quoted on the exchanges in the percentage of their face value, the fair price would be 121.6 percent.

### 6.3. Conclusion

There are several motives for family businesses when making decisions on the proposed timing and form of introducing new sources of funds to their operation. One motive of family firms that is likely to impact on their financing decisions is the willingness of the main owner to dilute their control over the business. (Keasey *et al*, 2015). The organization's life-cycle stages represent another variable in financial decisions.

In this chapter we enlisted the main sources of external funds, including the venture and equity capital for the first. We noted that – as opposite to bank financing, lending –bond financing is usually hard to use for a family business in Europe, but we made assumptions in order to define real price of a bond can be useful in other investment decisions, such as new machines, start new ventures etc.

#### 6.4. Reflective Questions

1. Critically discuss advantages and disadvantages of an overdraft facilities for family businesses.
2. Evaluate how family businesses can raise bank loans from traditional banks?
3. Discuss and evaluate how small business managers can develop growth strategies for future.
4. Critically evaluate how family business owner can enrich their current and future growth strategies.

## UNIT 7: Taxation and dividend policy

Once the business is profitable, we have to share our gain with the state (i.e. pay taxes) and the shareholders may decide to redraw some of their return to cover their personal needs. Family businesses behave in both cases somewhat special due to the influence of personal and family values and culture.

### 7.1. Corporate taxation

Tax compliance and planning represent one of the largest functional areas of business practice. Corporate income tax and personal income tax referring to entrepreneurs vary from country to country (some smaller family businesses can be a subject to personal income tax).

There is neither a common tax base nor a common tax rate within the European Union. No common tax base means that different taxable income and taxable expenses can be included in the tax base even if exactly the same business events happen to the firms. Hence, even if we apply the same tax rate to two companies taxed in two different countries, it does not mean that they will pay the same amount of tax. The idea of the Common Consolidated Corporate Tax Base (CCCTB) as a single set of rules to calculate companies' taxable profits in the EU has been widely discussed for twenty years. In 2016 the European Commissions' proposal on the Common Tax Base was issued and it is expected the attempts will be made to implement the concept.

Also, the tax rates are very diversified. They range from 0% in tax havens to 45% in the United Arab Emirates. The USA has 40% average tax rate and Argentina 35%. Often, not only one income tax is levied on a company but also tax burden compounds on several levels - for example state and local taxes. The Table 1 presents 2017 corporate tax rates in selected EU countries.

Table 1 Main corporate income tax rates in the EU

Country	Tax rate	Remarks
Austria	25%	There is also a minimum corporate income tax of EUR 1,750 for limited liability companies and EUR 3,500 for joint stock companies.
Bulgaria	10%	-
Croatia	20%	12% rate applies for enterprises with annual revenues up to HRK 3 million.
Cyprus	12.5%	-
Czech Republic	19%	A special rate of 5% applies to profits of funds if at least 90% of the fund's property is invested in investment securities, market securities etc. There is also 0% rate for pension funds (with certain exemptions).
Denmark	22%	-
Estonia	20%	-
Finland	20%	-
France	33.33%	A social surcharge of 3.3% applies to companies with a corporate income tax liability exceeding EUR 763,000 (bringing the top corporate rate up to 34.43). A reduced rate of 28% applies to the first EUR 75,000 of taxable income of small and medium-sized companies with turnover of less than EUR 50 million
Germany	29.79%	The overall corporate tax rate can range approximately between 22.83-36.83% due to local trade tax rates
Greece	29%	-
Hungary	9%	There are notable special taxes on banks, financial enterprises, insurance companies and for companies active in the energy sector.
Ireland	12.5%	A corporation tax rate of 25% applies to passive income and to income from certain defined activities.
Italy	24%	Banks and other financial institutions are taxed at 27.5%. Non-operating companies are taxed at 34.5%. There is an additional regional tax on productive activities.
Latvia	15%	-

Source: OECD and KPMG (2017) databases

Table 2 cont. Main corporate income tax rates in the EU

Country	Tax rate	Remarks
Lithuania	15%	A reduced rate of 5% applies for some agricultural companies.
Luxemburg	27.08%	A 15% rate applies if taxable income does not exceed EUR 25,000. Between EUR 25,000 and EUR 30,000, the corporate income tax rate is EUR 3,750 plus 39% of the income exceeding EUR 25,000. The corporate income tax rate of 19% applies to companies whose taxable income exceeds EUR 30,000. The corporate income tax rate is increased by 7% for contribution to the employment fund. Municipal business tax also applies and varies by locations.
Malta	35%	-
Netherlands	25%	Companies that have been awarded with the registered manufacturing status are subject to a tax rate of 18% for a period of 10 years. Mining activities are taxed at rates ranging from 35% to 55%.
Poland	19%	A reduced 15% tax rate may apply to small companies and start-ups.
Portugal	21%	The corporate income tax rate of 21% is increased by a municipal income tax and progressive state surcharge on taxable profit. Small and medium enterprises may benefit from a reduced 17% CIT rate.
Romania	16%	Special tax rules are applied for nightclub, disco and casino activities and companies that carry out hospitality activities (e.g. hotels, restaurants, catering).
Slovakia	21%	-
Slovenia	19%	A special rate of 0%, which, subject to certain conditions, may apply to investment funds, pension funds, insurance undertakings for pension plans, and qualified venture capital companies.

Source: OECD and KPMG (2017) databases

Country	Tax rate	Remarks
Spain	25%	Some of newly created companies conducting business activities are taxed in the first tax period showing positive taxable base and the following tax year at a rate of 15%.
Sweden	22%	-
United Kingdom	19%	Rate was reduced to 19% on 1 April 2017.

Source: OECD and KPMG (2017) databases



We can observe different models of the relationship between tax and reporting systems. In general, it is possible to distinguish three approaches.

(1) The first approach is a system where accounting practices are largely influenced by tax rules. Companies are not allowed to make any entries in their books that are contrary to the tax rules. For the external purposes, the financial statements have to be recalculated according to the international accounting standards.

(2) The second model is where financial statements are generally based on accounting principles and standards with a few exceptions, which are influenced by tax implications. This situation arises in countries where tax laws do not stipulate any particular methods of presenting of the financial accounts. In these countries, the financial statements are drawn up in accordance to the general accounting principles and can be used to determine the basis of tax assessment. In practice, many exceptions from this general rule can be observed in order to reflect certain tax implications. Tax considerations may prevail over the general accounting principles if, for example, there are potential tax advantages in a specific treatment or interpretation.

(3) The last approach is where there is a separation of the accounting principles and methods from the tax rules. There are two sets of rules: accounting and fiscal operating independently and in principle they do not interact. This means that businesses are free to record their transactions in accordance with the accounting principles but at the same time must calculate a separate base for the tax assessment.

This distinction is drawn up somewhat arbitrary. In many countries, we find mixed models containing elements from more than one approach but it should be pointed out that almost in every case taxable profit represents the different value from book profit. For example, the most common expenses that are not taxable in many countries are: fines, penalties, accounting provisions and impairments, accrued (but not paid interests) etc. Therefore, it should be clearly pointed out that:

- (1) Taxable expense  $\neq$  Accounting expense
- (2) Taxable revenue  $\neq$  Accounting revenue
- (3) Taxable profit (loss)  $\neq$  Accounting profit (loss)
- (4) Reported tax expense (tax income)  $\neq$  Tax paid

Referring to the last issue, there are “two kinds” of tax in financial reporting: current tax and deferred tax. Current tax is simply the amount which is payable to the tax authorities for a certain period. It is usually straightforward.

Deferred tax is a kind of accounting adjustment for tax calculated in compliance with tax rules. This accounting measure considers the future tax consequences of every transaction, which influenced the accounting profit for the current period. It reflects the idea of the matching principle (we try to match profit and tax). It is believed that thanks to this, accounting profit is less distorted by tax regulations. You can see the deferred tax

items in the statement of financial position as 'Deferred tax asset' and 'Deferred tax liability' and in the Statement of profit or loss, as Deferred tax item which can be found between gross and net profit.

Managers generally try to minimize effective tax expense. There are many ways to optimize in a legal way the family firm's tax burden. For example, the structure and legal form of family businesses should be carefully designed. The unlimited liability structures such as a sole proprietor or a partnership usually means that in a case of business failure the involved individuals could lose their personal wealth. On the other hand, choosing the corporation structure leads to a double taxation. The earnings are taxed first at the corporate level and again when they are paid to shareholders in a form of dividend.

We observe many "tax-driven" business procedures and behaviours. Sometimes it is only just tax planning in the context of forecasting the amount of tax payable. Many firms make decisions and choose projects having in mind the tax consequences. This process of controlling actions to legally avoid undesirable tax consequences is called "tax avoidance" and should be distinguished from illegal "tax evasion" (Rice 1993, .p. 5). Tax avoidance practices especially can cause distortions in the financial reporting. Table 2 below summarizes the potential influence of different types of discussed behaviours on the quality of the financial reporting. The degree of the influence can of course vary depending on the circumstances.

Table 3 Possible influence of tax-driven behaviours on quality of the financial reporting

Behaviour	Impact
"Tax-driven" investment decisions	Relatively small or no distortion
Operating decisions resulting in deferred tax payments	When full disclosure requirements are satisfied (e.g. in footnotes) the users of the reports should not be misled
Optimization of transfer pricing between subsidiaries used to minimize tax liability	Financial statements may not fully represent the true sustainable profitability or earning potential of the employed assets - especially in respect of the individual subsidiaries
Electing where possible the tax basis over the accounting principles in financial reporting	If materiality concept is broken a distortion in all elements of the financial statement can be observed
Not registering some of the transactions to reduce tax (observed especially in small businesses)	All financial statement can be worthless

The tax-driven behaviour can be observed in larger as well as in smaller organizations. The problem becomes even more difficult for multinational corporations, which must deal with various tax-law jurisdictions. In case of the multinational groups, the biggest threat seems to be in misuse of transfer pricing to siphon off the taxable profits to the tax havens, depriving the governments of the other countries where the corporation operates of taxes normally due to them (Sunder 1994, p. 179).

The U.S. Treasury has estimated that transfer pricing manipulation resulted in at least \$12 billion in lost tax revenues during the 1980's decade (Evans et al. 1994, p. 467). At the same time, larger corporations are usually publicly listed and their management is motivated to show sound profits to the shareholders in order to grow the share price and to attract new capital for further expansion. However, higher profits may mean higher tax liability hence lower net profits.

By contrast, small businesses and closely held private firms do not need financial statements to provide an "unbiased" estimates of wealth or income and do not to have to impress themselves by reporting higher than legally necessary profits as these statements may only increase the tax liability. In such organizations tax minimization and cash flow maximization is the primary concern in designing of the accounting system. A proprietor may also prepare informal statements for personal use (Sunder 1994, p.177). Research by Marfolla and D'Amico (2016) shows that too much family involvement (which is otherwise beneficial) causes the detrimental outcome of higher tax aggressiveness. Although other researchers (Chen et al 2010) suggest that firms run by founding family members are characterized by a unique agency conflict between dominant and small shareholders. They found that family firms are less tax aggressive than their non-family

counterparts. This result suggests that family owners are willing to forgo tax benefits to avoid the non-tax cost of a potential price discount, which can arise from minority shareholders' concern with family rent-seeking masked by tax avoidance activities.

## 7.2. Payout policy at family businesses

Dividend is defined as transfer made by the firm to its shareholders. Dividend is one of the main forms of revenues a business owner may collect. In case the company is not listed, very often this is even the only revenue to the shareholders. Family members who work for the company may see dividends as an alternative for salary and very often try to optimise tax by choosing between these two forms. In case some of the owners are not employees, this may lead to a conflict of interest: on one hand, high wages paid to some of the owners would reduce the dividend payment to all of the shareholders. On the other hand, if owner-employees do not get the fair market based wage, any cost saving would be distributed among all shareholders and not paid completely to those earning less.

Dividend payment may happen with various frequency. While European firms and smaller companies worldwide tend to pay dividend once a year, bigger US companies usually pay a quarterly dividend. An extraordinary dividend may be also paid once the firm receives huge amount of liquid money that it would not need for its operation (e.g. when selling a business unit). Liquidation dividend is paid to distribute any remainder of wealth after repaying all the liabilities.

Theoretically, there are various forms of paying dividend. (Brealey, Myers, & Allen, 2011, Ch. 16) These include the following.

(1) Cash payment. The classic method of dividend payment is when the firm transfers money to the shareholders. Share price is expected to fall by the amount of the dividend per share. This solution is quiet costly and risky. It may jeopardise the liquidity of the firm and limit funding of projects, thus loss in value may even be bigger than the amount of cash paid. Also transferring to various shareholders a relatively small amount of money may lead to high banking cost covered by all shareholders regardless whether they wish to receive money at all. Some investors may prefer to keep their capital invested in the company, as they need no cash (e.g. their wage is enough for living). They are still forced to receive cash and cover the transaction costs. Once the firm is not listed they can not reinvest any inflow to the same company, so their personal portfolio has to be rebalanced after each dividend payment. Due to these some owners may consider cash dividend as unfair.

(2) Stock dividend. In this case, the firm would transfer some its shares for free to the owners proportional to their holdings. As the value of equity does not change but there will be more shares outstanding, the price of one single share will fall. This implies that those needing cash would cover the transaction costs of turning the shares into money, while those who would prefer to keep their capital invested in the same firm do not see their portfolio weights changed and have to do nothing. Of course issuing new shares could be a lengthy process and may cause significant transaction cost if the firm has to

go through regulatory procedures. That is why those are the firms who hold some of their own previously issued shares for some reason that usually apply a stock dividend. If issuing more than 25 percent of the previously outstanding shares, the transaction is considered as a stock split rather than a stock dividend.

(3) Share repurchase. This technique allows for the company paying money only to those shareholders who wish to have some income while all others may keep their investment. Transaction cost are reduced as not all owners will receive a transfer but the expenses all covered by all the shareholders. Listed companies may use share repurchase to send a message to the market: if executives decide to purchase shares at a given price, they show that they believe the fair value is higher and consider the shares of eth company as a good investment. Own shares accumulated this way may be used not only in executive compensation programs (members of the top management may get the shares at a reduced price), but it may also make possible to pay a stock dividend at a later point in time.

(4) Property dividend. In some uncommon cases, the firm may decide to distribute some non-monetary assets (e.g. shares of subsidiaries) among the shareholders. These transactions should be recorded at market value so there could be a tax effect due to any difference between the market and book value. That is why sometimes the main aim of this kind of dividend is to optimise tax.

In case of non-listed family businesses, the most common payout method is cash dividend. Thus, we will focus on that in the rest of this chapter.

But what is the optimal level of dividend payment? We have to consider various factors before taking a decision.

(1) Taxation. Dividend income of owners is usually taxed at a higher rate than price gain. Thus, if it possible for the owners to sell their holdings on the market, they may prefer not receiving a dividend.

(2) Financing. Any form of dividend reduces equity. Available outside financing sources (see Chapter 7) are usually limited in a certain percentage of the shareholders' capital. Thus reducing equity may lead to a decrease in funding in general and may limit future growth opportunities.

(3) Liquidity. Does the firm have enough money to pay for the dividend? If owner set the amount of dividend only based on their need but not the possibilities of the company, dividend payment may lead to a liquidity shock. This is why very often dividend payment needs a careful timing and it is common that a dividend legally accepted by the owners will not be paid until several years later.

In the 1960's, Miller and Modigliani showed that if no taxes and transaction costs exist, and operational and investment policy is fixed (that is adequate funding is assured regardless of eth amount of dividend) the amount of dividend has no effect on the value of the firm (Brealey, Myers, & Allen, 2011, Ch. 16). However, in the real life have no such conditions fulfilled.

The rules of value based management (see Chapter 3) require executives to invest into all projects that increase shareholder value and fit within the available financing bracket while assuring smooth ongoing operation. At the same time, top managers are also assumed to find the optimal financing structure. Thus, both operational, investment, and financing policy are fixed, and we may exactly predict the equity need of the company. As it is always cheaper to provide the required increase in equity form reinvesting current period profit, than from issuing new equity, the amount of gain available for payout can be calculated. This means that if value based management is applied (i.e. decision maker focus on maximising shareholder value), executives and owners have to decide on operational, investment and financing issues only, dividend is then is to pay on a remainder bases.

While the dividend decision may seem to be marginal from the point of view of these models, it is vital to see that for a minority shareholder or a non-active family member dividends are the only income on their investment into the company. For these parties payoff decisions of eth firm are the most important ones.

Do family firms pay more or less dividend? There are three competing theories describing the connection.

(1) The expropriation hypothesis emphasises that any cash remaining within the firm is under the control of the family, while dividends have to be shared with potential outside investors (e.g. minority shareholder in case of listed firms). The situation is more complex if there are non-active family member shareholders in a private company the amount and stability of the payment to whom (e.g. friends, parents, relatives) could have strong emotional or social importance for the active members.

(2) The reputation hypothesis builds on the social capital of the family. To strengthen recognition and show profitability of the firm more dividend should be paid than in case of non-family businesses where there is no social capital effect. In case of listed firms, investors might look at more complex measures, but the signalling effect to small minority shareholders could still be important. At the same time, social capital can be increased by philanthropy that could be both done by the firm (reducing dividend payment) and the owners (calling for more dividend).

(3) The family income hypothesis predicts that it is the cash need of the family that determines the amount of dividend. Due to this, the payoff might be more independent from the amount of yearly profit and should be higher than otherwise, as usually the business is the major source of income for the family. This argumentation may not apply in case of huge, listed companies. Also, if most of the family members work for the company, wages can be used as a main income and then taxation issues may have the final say about the preferred payment.

Just like these theories, research results are also somewhat contradictory: we have proof for lower payout ratios form Austria, the US, and Germany, but for the opposite from Australia and Switzerland, while in Spain, no difference was found (Attig et al., 2016).

At the same time, we have to be aware of the fact that most of these researches focus on listed companies where dividend payment may serve as a corporate governance toll. By requiring the firm to pay a stable amount of cash to owners minority block holders may hinder majority family owners to take advantage of their position and use the business resources to their own benefit only.

Focusing on nine Euro zone countries, Pindado, Requejo, and Torre (2012) found that family firms pay higher and more stable dividend than other companies. This result is significant mainly due to the companies that do not separating between the largest owner's voting and cash flow rights and those with non-family second blockholders. In other words, firms where family owners have more influence on the business than their proportional ownership would assume, dividend payments are cut back and most likely used as family resources (e.g. more generous compensation for family employees). The authors highlight the importance of considering not only the main owner but also the whole governance structure when analysing the dividend policy.

Setia-Atmaja (2010) analysed a sample of Australian listed companies over the period 2000 to 2005. He concluded that family-owned firms on average pay higher dividend and use more leverage than non-family counterparts do. Still, the higher dividend payoff was mainly due to the firms employing higher proportion of independent directors, in other words less family dependent governance would lead to higher payout. This means, that external directors are more likely to prevent expropriation of the business resources by the family.

Tina, Wilson, and Gordon (2012) compared the dividend behaviour of state-owned and family-owned businesses based on a sample of large industrial firms from the Hong Kong Stock Exchange. They found the state-owned firms to have higher and more stable dividend payments. This could be explained by the more adequate source of financing available for state-owned companies (state owned firm were cross-listed from mainland China), by the dividend payment serving as a monitoring tool for management quality in case of state-owned firms, and by family owners having more fluctuation in their cash need. They conclude that family businesses have a stronger control of the management due to more shareholder activism and do not need to ask for stable dividend to hinder executives to use company resources to their own purposes.

Attig et al. (2016) also concluded that family ownership is negatively related to dividend payout in nine East Asian economies (Indonesia, Japan, Hong Kong, Malaysia, Philippines, Singapore, Thailand, South Korea, and Taiwan) in the period 2006 to 2010. The connection was stronger especially during the financial crisis period when financing was harder to get from other sources. Family firms tended to have less liquid reserves and cut more on investment expenditures that could be explained by a shortage of financing. At the same time, corporate governance also played a role. Controlling families particularly tended to expropriate corporate resources in companies with more pronounced agency problems.



Focusing only on Indonesian listed firms for the period 2003 to 2009, Setia-Atmaja (2016) also found a significant negative connection between family ownership and dividend payment even when controlling for firm size, age, growth, financing policy, and profitability. Mulyani, Singh, and Mishra (2016) found the same negative connection on the Indonesian market for the period 1990 to 2011, but they also showed that family businesses had a higher leverage than counterparts. This result is in line with the expropriation theory and contradicts to the common explanation that lower dividends are due to more limited access to other sources of funding.

San Martín Reyna (2017) investigated the effect of ownership on dividend policy. After his results based on a sample of listed Mexican firms for the period spanning from 2005 to 2013, family ownership decreases dividend payment while institutional ownership increases it. He underlines that dividend payments served as discipline mechanism to control the top management by reducing the available cash flow. This is needed because in Mexico, like in most emerging countries, the legal protection of the investors is weak. This is counterbalanced either by the members of the owning family being directly involved into the control or in case of institutional investors, by the higher dividend payout request. The poor legal defence of investors is underpinned by the fact that the type of minority shareholders did not play any significant role in the dividend policy.

Table 4 Key influencing factors of dividend payment

Lower dividend	Higher dividend
Nepotism, parental altruism (e.g. overpaid family-member employees)	Tax advantage of dividends over wages
Difficult access to external financing	Presence of non-family blockholders
High capital need (e.g. high growth)	Presence of passive family shareholders
Low or hard-to-predict liquidity	Established family governance practices
Legal limitations (e.g. debt covenant)	More external directors on the board
Earlier generation controlling the firm	Strong legal protection of minority owners
Family CEO	More professionalised management
Family dominated board	High cash need of the owner family
	Huge amount of unneeded cash within the firm

Michiels, Uhlaner, and Dekker (2017) point out that size could play a very important role in dividend payment decisions. Private family businesses often postpone growth-promising investments rather than issue new (i.e. external) equity to avoid the possible weakening of family control. Using a sample of 492 mid-sized private Belgian family business, they found that more professionalised family businesses usually pay higher dividend, than those with less professionalised governance. The stronger the financial control system, the non-family involvement in governance (continuous outside control), and the human resource control system (lower room for nepotism) were, the higher the average payout amounted. They underline that dividends should be the outcome of a strong governance system and not the substitute of that.



It seems that even the kind of people working in the boards matter. Vandemaele and Vancauteren (2015) used a sample of 501 Belgian private firms and concluded that companies with a family CEO or a family dominated board tend to pay less dividend than other companies. This effect is stronger if the company is in the hands of earlier generations.

Michiels et al. (2015) underline the importance of intra family-conflicts. They investigated the effect of these conflicts emerging among active and passive family owners on a sample of 244 Belgian private family businesses. Their results imply that the existence of intra-familial conflict of interest would lead to higher propensity to pay dividend.

Based on their results, the use of both formal and informal family governance practices (FGP) has also enhanced the dividend payment. FGP is a distinct governance system dedicated to solve potential conflicts within the family itself and create a shared vision among active and passive family shareholders. Earlier research showed that the application of FGP boosted cohesion and mutual trust, leading to a competitive advantage and superior firm performance.

Based on these findings, it seems that there could be more difference among dividend policies of various family businesses than between family and non-family firms. Regulations, corporate governance techniques, ownership and firm characteristics, and tax considerations all have an influence on the payout. Table 3 sums up the most important factors affecting the dividend payment of family firms based on the literature review.

### 7.3. Conclusion

Taxes represent a significant cost to the firm and the owners. The income tax is not an item harmonized in the European Union. There is neither a common tax base nor a common tax rate within the EU. When designing the family company legal structure, taxation is an important issue and one should be aware of such problems as double taxation.

The taxable income is a different category than accounting profit. The reported company profits can be seriously distorted by an aggressive tax policy. Family companies tend to have a high temptation for using an aggressive tax minimization policy. The non-family minority interests can reduce these practices.

Dividend payments may happen with various frequency and in various forms. Usually family businesses pay dividends once in a year in form of cash. There are various factors effecting the amount of payout. It is not only the characteristics of the industry (uncertainty of operation, fluctuations, growth opportunities) and those of the firm (size, age, financial control) but also the ownership structure (passive family members, external blockholders), the individuals in the board (controlling generation, external members) and the culture and life of the owner family (philanthropy, cash need, family governance) that have an important influence.

#### 7.4. Reflective Questions

1. Why do firms pay different amount of tax even if the same business events happen to them?
2. Should family businesses be taxed differently? Why?
3. What are the main factors influencing dividend payments of family businesses?
4. Is there an optimal level of dividend payment? If so, how should we find that?

## UNIT 8: Performance management at family businesses

Company owners are deeply interested in controlling economic resources invested in the business entity. To be efficient in that, they need reliable information organized in an understandable and coherent way. Meanwhile, the body of information describing even small family firms is enormous. The popular way of assessing the company performance is to use financial measures. In this chapter, the major financial performance measures will be explained while applying the perspective of family businesses and its stakeholders. We are also going to focus on the qualitative characteristics of the information, which is an input in the measurement process and the actions that can be undertaken by the family members to get true and fair information about the family business' performance. Therefore, the measurement is to be placed into the framework of the value-relevance of accounting information for family-owned firms, as the stakeholders would consider the reported information neutral and consequently faithfully represented.

### 8.1. Why do we measure?

Measuring financial performance and efficiency is a key issue, not only for the managers of family businesses, but also for all company stakeholders. Measuring performance on the basis of financial data is a means of describing company performance in an objective way. On the other hand, it should be clearly stated that there is no one, universal way to measure financial health and long-term viability. Every entity is a single unique case, and in the process of evaluating company performance, the following key questions should be addressed:

- a) What kind of economic/financial data are available for the company?
- b) Who are the intended users of financial performance measurement?
- c) What are the main targets of the intended users?
- d) What kind of benchmark can be used in the analysis?

Referring to the issue of available information, it is worth mentioning that even in smaller enterprises the body of information describing their performance can be enormous. On the other hand, only some information might be useful and coherent with the aims of the analysis. Many financial experts believe the best set of financial data for measuring company performance is data collected within the double accounting system. The final products of this system are financial statements, such as a statement of the company's financial position (balance sheet), profit and loss statement and a cash flow statement. However, in some countries, smaller family companies can run simplified books or even be obliged to collect some selective data for tax purposes. In these cases, collecting useful basic financial data can be difficult or even impossible. Stakeholders in these companies should consider implementing at least some elements of financial reporting based on double accounting.

The next important issue is the range of the performance measurement's intended users. Most companies, even small ones, usually have a diverse group of internal and external stakeholders, such as management, employees, shareholders, banks, suppliers, customers, tax authorities, government etc.

The company's stakeholder groups usually have different targets, and focus on different financial measures. Their needs should be clearly communicated to those in charge of supplying financial information. For example, a key issue for banks can be liquidity and solvency, while family owners can be focused on long-term profitability. That is why it is impossible to build one universal performance and efficiency measurement system.

Then, in designing a company performance measurement system, it is crucial to identify the goals of the selected stakeholders. The body of information that can be prepared on the basis of a typical company accounting system can be enormous, so stakeholders should decide what kind of information on performance should be gathered and controlled. The simplest way to do this is to apply the cost-benefit test.

Another critical issue in measuring company performance and efficiency is to employ appropriate benchmarks. When writing financial literature, authors often state that the accepted level of net liquidity ratio, for example, is above 1.8. Such "benchmarks" in the literature should be treated with caution. Every industry operates within specific circumstances – with a long or short operating cycle and the involvement of different sets of assets, so referring to an industry average is usually a far better idea.

It seems companies providing the same services generally encounter similar problems. However, it is worth remembering the estimation is only still a rough approximation. Even within one industry, companies vary in size and their products are not exactly the same. For example, we could compare the Volkswagen Company with a manufacturer of vintage Italian car replicas. Although both companies operate in the automotive industry, their markets and customers are different and they face different risks. Moreover, by comparing performance/management with the industry average only informs us that our management is as good as, or worse than, the average of companies. Preparing a more detailed search, including analysis of medians, modes or quartiles can result in more informative outcomes. Additionally, a company can be a good benchmark for itself. An analysis of time trends can be very informative, and a survey of past policies and their effects on performance measures can be very helpful for decision making and formulating future policies.

### 8.1.1. Looking for a relevant benchmark

The owner of a local, family-owned company trading in building materials found that the company had earned only €0.03 per €1 of sales revenue the previous year, and only €0.02 for the past year. He knows this relationship is a commonly used measure ROS (Return on Sale). Being concerned about the company's financial health, he uses publicly available data on the Internet, and finds that the average value of this measure for listed companies in his country is €0.03 (ROS = 7%) and for commercial companies it is also €0.03. Should the owner be concerned about the level of profitability of his company?

In fact, the owner does not use adequate benchmarks to assess the company's profitability. The stock market's population is too large and the group of listed companies, which includes service, trading, and manufacturing companies, is too diverse. The group of trading companies is a little better, but still the group is too divers. The rates of return on clothes, luxury cars and construction materials can be significantly different. The entrepreneur should find the benchmark of the company leading the closest possible group of businesses.

You also need to look at whether the whole group of listed companies is a good benchmark, taking into account the size of the business (we can measure this by the total of the balance sheet or sales revenue), and the markets in which the companies operate (international, local etc.). Probably the best benchmark for his company would be its local competitors or similar companies operating in neighbouring local markets. Regarding the outcomes, he might find that for the industry such a low rate is typical. It could be caused, for example, by a high level of competition in the market or generally low margins used in this industry. Similarly, the decrease in the ratio may have been caused by a crisis in the construction industry, and all the companies may suffer in a comparable degree.

### 8.2. Ratio analysis

The most common and useful method for evaluating company performance is ratio analysis, which involves comparing chosen figures from financial statements. Many owners, especially of SMEs, do not realize that its meaning goes far beyond the use of a supporting device for applying for credit, loans or EU funds. There is no established set of standards; they vary according to the analytics' customs, the purposes of the analysis and other factors. Below, we discuss the most popular ratios and their significance for family companies. We are also going to show the possible misunderstandings that can arise when using these ratios.

We can distinguish five main groups of ratios:

- a) Liquidity and solvency ratios,
- b) Debt (leverage) ratios,
- c) Profitability and return ratios,
- d) Efficiency ratios,
- e) Market value ratios.

Liquidity is the ability of the firm to come up for its payments due. Liquidity often gives managers and owners of family businesses sleepless nights. Assets are liquid when they are cash or relatively easy to convert into cash in a reasonably short period. For example, liquid assets are trade receivables, exchange receivables, short-term investments and inventories. Usually, liquid assets can be found in the section on non-current assets in the statement of a company's balance sheet.

In very rare cases some adjustments are needed. For example, when a company reports that accounts receivable are expected to be paid over 12 months, they should not be treated as liquid assets. Liquidity ratios should be observed on an everyday basis and can signal upcoming bankruptcy. The most commonly liquidity ratios are listed in Table 1, as follows.

Table 1 The most commonly used liquidity ratios.

	Ratio	Way of calculation
1	Current ratio	Current assets / Current liabilities
2	Quick ratio (acid test ratio)	Current assets less inventory / Current liabilities
3	Cash ratio	Cash and cash equivalents / Current liabilities

The idea of measuring liquidity comes from the assumption that a healthy company should obtain cash from sales of goods and services to pay its short-term debt, rather than from selling its non-current assets, taking out new loans or issuing new equity. The idea behind this is that companies should have enough liquid assets to meet their future commitments to pay off their current liabilities, when the save threshold of this ratio is above 1. In practice, as we have already mentioned, comfortable levels of this ratio vary from industry to industry.

When calculating a quick ratio, inventory is excluded as it is perceived to be the least liquid current asset. Raw materials first need to be converted into finished products so could start selling them. Once being successful, we have to wait further until customers will pay for their purchase. As when in need, raw materials may be sold in their existing form, we usually consider semi-finished products and work in progress as the least liquid item among current assets. Cash ratio only considers assets already in form of cash or short term deposit. When doing an analysis we may not only pick one of these ratios,

rather than calculate all of them and consider also the change of those compared to each other to get a better understanding of processes driving liquidity.

As far as family owned companies are concerned, it is worth mentioning the research of Yin Yu-Thompson et al. (2016), which shows that US family companies from Standard & Poor's 500 have higher balance sheet liquidity ratios than their peer non-family firms. This means they try to avoid costly external finance. By the way, it has also been proven that family companies have higher levels of stock liquidity and lower liquidity risk as measured by effective bid-ask spreads than non-family firms. The results are consistent with the motivation that organizations whose shareholders can efficiently monitor their managers are associated with higher levels of corporate and stock liquidity and lower levels of liquidity risk. The outcomes are coherent with general outcomes coming from different research (Miller & Breton-Miller 2006) that family businesses run more conservative financial strategies than non-family firms.

While liquidity focuses on a short-term perspective, solvency is associated rather with a long-term horizon. The key issue is the relationship of the company's debt to its size measured by gearing (or leverage) ratios. When this relationship is perceived "healthy and safe", the banks and other lenders will be willing to support the company with further funds. If trends in the index change are unfavourable, the cost of lending money can increase dramatically.

Below we discuss the most important ratios describing this relationship. They explain the extent to which a company uses debt financing or financial leverage. When financial leverage works properly, a firm earns more on investments financed by borrowed funds than it pays on interest. Then the return on the owners' capital is magnified or "leveraged". However, highly leveraged companies are exposed to the risk of loss when the economy goes into a recession.

According to corporate finance research, there is no one optimal level of debt. In each case, the relationship between the company's EBIT margin and the cost of capital should be studied carefully. The key issue is the level of risk the stakeholders accept. It is highly recommended that all interested family stakeholders should discuss a different long-term financing strategy and obtain all the stakeholders' approval of the chosen option. Their decisions could be supported with scenario/sensitivity analysis showing simple financial models illustrating the positive and negative effects of financial leverage.

Some research suggests that family companies tend to be less leveraged than non-family companies. This confirms the thesis about a more conservative approach to risk in family businesses. The two most common procedures used to examine a firm's debt are financial analysis of the balance sheet to determine the extent to which borrowed funds have been used to finance assets, and second, studying the company's profit and loss statement to check the extent to which fixed charges are covered by operating profits.

Table 2 The most commonly used debt ratios

	Ratio	Formula
1	Debt ratio	Total debt / Total assets
2	Debt-equity ratio	Long-term debt / Owners' equity
3	Leverage (gearing)ratio	Total capital invested / Owner's equity
4	Interest coverage ratio	EBIT(DA) / Interest charges
5	Debt service coverage ratio	(EBIT(DA) + Lease Payments) / (Interest payments + Principal repayments + Lease payments)

The debt ratio is calculated by dividing the debt by the total of assets. It equals total liabilities (both short and long term) divided by total assets, and measures the percentage of funds provided by non-equity holders. Generally speaking, the lower the ratio, the lower the risk of not getting your money back in the event of the company going into liquidation. A debt ratio that exceeds the industry average can be perceived as a red flag and may make it costly for a firm to borrow additional debt funds.

The debt to equity ratio equals the firm's long-term debt divided by its equity. This ratio supplements the information often used by long-term creditors. They rather prefer lower values for this ratio, which implies lower financial leverage used by a company.

The leverage ratio describes how much capital can be moved by one unit of equity. To calculate the ratio long term liabilities and equity should be summed up to total capital invested and we have to divide that by the equity employed.

The interest coverage ratio is computed by dividing earnings before interest and taxes (EBIT) by the interest charges. It measures the extent to which operating income can decline before the firm is unable to meet its annual interest expenses. EBIT is used in the numerator because interest is paid with pre-tax income and the tax does not influence the company's ability to pay this. It should be pointed out that it is a pretty simplified measure because EBIT actually does not represent all the cash flow available to service debt (for example, it is decreased by depreciation and amortization, which do not absorb money). Thus, instead of EBIT we may also use EBITDA (earnings before interest and taxes, depreciation and amortisation) in the calculation.

The Debt service coverage ratio is a more complex measure of a firm's ability to pay its debts as it considers the total cash flow need of debt service. This ratio is useful for relatively short-term lenders. In a long-term horizon, the company needs to replace its fixed assets, so amortization and depreciation in this sense correlates with future monetary payments. Thus, the use of EBIT in the ratio can also be justified.

Net profit or its components, such as EBIT (earnings before deducting interest and taxes) are the most commonly used measures to evaluate a company's performance. It can be noticed that some research suggest that while outside investors typically have a stated



goal of profit maximization, family investors combine altruistic and profit motives (Gómez-Mejía et al., 2001; Schulze et al., 2001).

From the perspective of a family business, profit and measures calculated on the basis of profit can be a useful tool for assessing management's efficiency and the settlement of family members. Gaining profit allows a company to pay out dividends, which can be expected by family members' financial flows. For smaller family businesses run as sole proprietorships it is usually possible to transfer capital between the company and the owner without any formal constraints, regardless of whether profit is reported or not. It depends on the legal regulations of the country.

The key issue is to make sure that profit is measured fairly and in compliance with the accounting standards accepted by the entity. It is important to remember that profit and the principle of its measurement are "human made" concepts; they are a kind of contract and values measured in accordance with different accounting standards, and can give different results. It is possible that a company can show a profit according to one accounting standard, while another accounting standard might reflect a loss. Within the European Union, the general principles of financial reporting are standardised by the European Directives. However, this does not exclude the application of different accounting standards in Member States. Generally, International Financial Reporting Standards (IFRS) and local standards are in use. Family stakeholders should be at least aware of the general principles of measuring profit and accounting standards used in a particular company.

From the point of view of family members, regardless of their involvement in day-to-day business management, it is important for all concerned to be convinced that profit, as the main measurement of family performance, is measured in a "true and fair" manner. Trustworthy profit measurement and reporting systems can effectively help prevent conflicts and stabilise the ownership structure. Of course, it is difficult to expect all family business owners to have expertise in accounting and finance and the ability to devote the amount of time required to keep track of the company's accounting. Therefore, attention should be given to two institutions that can be used in a family business: external audit and audit committee.

Employment of an external financial auditor may be mandatory in some countries and depends on the size of the company. However, in the absence of such an obligation, a financial audit contract with an independent specialist can bring significant benefits to all stakeholders. The principal tasks of the auditor as far as profit and profit-based measures are concerned, is to determine whether they have been accounted for and recognised in accordance with the applicable accounting standards. However, in the case of family businesses, the auditor may, on behalf of the interested stakeholders, control the owners' withdrawals, mutual settlements among family members, and the level of the expenses incurred by the management. In any case, the auditors' employment should be preceded

by a meeting explaining the specific expectations of the owners and managers of the family business.

Regarding profitability assurance and the other measures, an audit committee can be a meaningful body. It is an operating committee of a company's board of directors or supervisory board (depending on the legal system of the relevant country) that is in charge of overseeing financial accounting and reporting. In EU countries (with some exceptions), publicly traded companies must have a qualified audit committee. At least some of the audit committee members must be highly qualified professionals in the field of accounting and finance. Audit committees maintain communication with the company's chief financial officer (CFO) and controller. Audit committees usually have the authority to initiate special investigations in cases where they determine accounting practices are problematic or suspect. The audit committees can maintain an oversight of financial reporting, monitor accounting policies, oversee any external auditors and do any task in financial affairs entrusted by family members.

The accounting literature shows (Chen & Nowland, 2010) that in the case of publicly listed family companies, and generally when minority interests are involved in a family company, establishing audit and remuneration committees is important for the company's performance. The optimal level of management's monitoring is sensitive to the magnitude of the agency conflict between the family group and minority shareholders and should be designed for each company separately.

Profitability ratios measure the combined effects of management's activities. They portray the success of the firm in earning a net return on sales or on investment. The most popular ratios are presented below.

Table 3 The most commonly used profitability ratios

	Ratio	Way of calculation
1	Gross profit margin	$(\text{Sales} - \text{Cost of goods sold}) / \text{Sales}$
2.	Basic earnings power ratio	$\text{EBIT} / \text{Total assets}$
3.	Return on sales (ROS) ratio	$\text{Net income} / \text{Sales}$
4.	Return on assets (ROA) ratio	$\text{Net income} / \text{Total assets}$
5.	Return on Investment (ROI)	$\text{EBIT} / (\text{Long term liabilities} + \text{Equity})$
6.	Return on equity (ROE) ratio	$\text{Net income} / \text{Owners' equity}$

The Gross profit margin is calculated by dividing profit from sales (Sales – Cost of goods sold) by sales. This margin combines the effectiveness of a pricing policy and production efficiency. Poor performance of this ratio indicates that the business is seriously ill. The basic earning power ratio is calculated on the basis of earnings before interest and taxes (EBIT) and total assets. It shows the "raw" earning power of the company's assets. Thanks

to using EBIT, the influence of taxes and leverage is eliminated. Then it can be useful for cross-company comparisons with different tax status, and leverage can be compared.

Return on sales gives information about profit per dollar of sales. In itself, it gives very general information and should be interpreted together with the other ratios or compared to competitors' performance. Return on total assets (ROA) equals net income to total assets. It measures the return on all the firm's assets. It represents the rate of return gained for all the firm's assets, so it is more an efficiency measure rather than a profitability ratio.

Return on investment (ROI) compares before tax profit for all investors (EBIT) to all invested capital that is the sum of equity and long-term liabilities. In some cases, we may need to adjust this ratio and include short-term loans into the total capital employed. This might be the case if those are permanently used to finance the firm not only seasonally applied to overcome fluctuations of cash flow across the year.

Return on equity (ROE) gives the company owners very basic and meaningful information. It measures the rate of return on each money unit invested by the company owners. It informs how well the company is doing in an accounting sense. It can be useful to compare the investment in family business with alternative forms of increasing capital, but of course we have to be aware of the different risk levels, too. Management's main objective is to maximize the value for the owners. When compared to required return for the given level of risk, this measure gives a picture of the company's success in fulfilling this goal.

Using profit as a performance measure has serious limitations, as it is with all financial measures of performance. It is worth remembering that in accordance with generally accepted accounting principles applied worldwide, accounting profit is an accrual, not a cash category. This means profit measurement is based on estimated wealth effects of transactions rather than on cash flows with clear time value. For example, the sale of goods or services on credit increases profit but does not influence the company's cash flows. Profit is therefore an abstract category; it does not represent any form of real asset. Therefore, a company reporting high profits may not have cash to cover its current payments or trade obligations. On the contrary, it is possible that a company is reporting a high loss and at the same time has enough money to pay all its liabilities.

The other limitation of profit as a measure is that the process of measurement depends strongly on fair professional judgement as mentioned previously. Those who prepare the financial statements can influence or even manipulate many accounting items. Such accounting items are depreciation, provision for debts, risks and asset impairment. These influencing practices are described as creative accounting, window dressing, earnings management etc.

There is a profit, but where is the cash?

The owners of a family business received an annual report from the CEO showing that the company had earned a net profit of €7.2 million. The company had increased its EBIT and net profit by 27% and 21%, respectively over the previous year. The ROA, ROS and ROE ratios increased significantly and were close to industry averages.

Following these data and the company's dividend policy, family members claimed a 50% dividend payment in two weeks. The CEO recommended something quite the opposite – that all profit be retained as earnings and no dividend be paid. He explained to the owners that an immediate payment of €3.6 million would decrease the company's liquidity dramatically and could even lead to bankruptcy. In the CEO's opinion, if the owners insisted on paying the dividend, the company would have to take a loan, but that would take about a month.

He explained that a new long-term trade agreement had been signed in the last quarter when the company had secured a reliable new international customer. This customer's orders would allow for the company's manufacturing capacities to be fully utilized. The new customer had already placed several orders, which had been partially prepared and delivered. The agreed payment term was 60 days – significantly longer than the usual 14-day term used for other customers. The implementation of these orders required the purchase of large batches of materials and the employment of new employees. Payment for materials was usually expected in 14 days and salaries payable were due at the end of each month. Carrying out the new order contributed to the increase in profitability, but significantly reduced the company's liquidity.

The CEO claimed that paying out the dividend should not rely solely on profit and loss statements and profitability ratios. Instead, they should also do the following.

- (1) Analyse the cash flow statement and examine cash flows from operations and investment and financing activities.
- (2) Examine balance sheet items and their changes over the year, such as: inventory, accounts receivables and accounts payable.
- (3) Investigate the length of the operating cycle and its changes.

The situation required careful analysis, especially because the extortion of a dividend payment from a profitable business without thorough analysis of the company's economic situation, could lead to its bankruptcy. Profit is an accrual category based on transactions and not on cash flows. Profit is a kind of abstract measure of performance illustrating whether or not the equity has increased. At the time of the dividend payment, the profit as part of the equity section on the balance sheet must be transferred to the owners using the real economic resources of the company.

The communication between the manager and the family owners in this instance was also imperfect. The CFO should, in such a situation, inform the stakeholders about the possible derogation from the adopted dividend policy, and inform the owners in advance to obtain their possible approval. Perhaps if an independent audit committee or similar independent advisory body existed, the owners would have learned about the problems earlier.

The last group of ratios is market value ratios, which are only of use when the company is listed. They refer to the market value of the firm or the equity, so they give management an indication of what investors think of the company's past performance and future prospects. Market value ratios are also quite useful for preparing benchmarks; however, their values can be very volatile because they depend on the current stock market situation.

Table 4 The most commonly used market value ratios

	Ratio	Way of calculation
1.	P/E ratio	The price of a share / net earning per share
2.	P/CF ratio	The price of a share / cash flow to equity per share
3.	P/BV ratio	The price of a share / book value of equity per share
4.	EV/EBIT(DA)	(Capitalisation + Long term debt) / EBIT or EBITDA
5.	EV/Sales	(Capitalisation + Long term debt) / Sales

The price/earnings (P/E) ratio can be computed as price per share divided by earnings per share. This shows how much investors are willing to pay per one dollar of reported (or expected) net profits. P/E values should be interpreted in comparison with industry averages. Usually, higher P/E ratios represent industries that are expected to grow strongly in the future (for example, the IT industry) compared to their required return level. The price/cash flow ratio illustrates how much investors pay for one money unit of cash flow available to shareholders. Thus, this measure is a kind of cash flow version of the P/E ratio. The P/BV ratio is computed as market price per share divided by book value of equity per share. It shows the market value of one monetary unit of invested equity. Capitalisation is the product of number of shares issued and current market price. Note that this is only a rough estimation for the market value of equity as you could not purchase or sell all the shares at the current market price. EV (enterprise value) is calculated adding the long-term debt of the firm and its capitalisation. We may compare EV to EBIT or EBITDA thus getting rid of any distortions due to different financing policies of the compared companies. EV/Sales ratio shows usually far more variance than the earlier rates, but has the advantage to be available even for loss-making companies.

### 8.3. Faithful representation of the family firm's financial performance

Ethical issues are an important part of the accounting practice. Fraud, creative accounting, window dressing etc. are usually associated with breaking of the ethical norms in the practice.

Information generated by the accounting system should be useful and should not provide false premises to decision-makers. Conceptual Framework of International Accounting Standards (IASB, 2010) deals with some matters connected with ethical issues. According to this document, to be useful, financial information has to be relevant and faithfully represent reality (IASB, 2010, QC4).

Financial information is relevant when capable of making a difference in decisions. It means that it should have predictive value (can be used as an input to processes employed by users to predict future outcomes), confirmatory value (it provides feedback about previous evaluations) or both. Persons involved in the process of preparing financial information in family businesses can often be focused on satisfying primarily the information needs of the family owners.

However, it should be remembered that, when it comes to information reported outside, the rules of professional ethics require taking into account the information needs of all stakeholders: non-family owners, banks, bondholders, government agencies. For example, for family members, one of the most important dimensions can be profitability (both as a confirmatory and predictive measure) while for creditors liquidity and solvency can be the crucial measures. What may be notorious information from the family members' point of view (risks, investment plans) may require clear and extensive communication to the users of financial reports.

Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent (IASB, 2010, QC11). To be a perfectly faithful representation, a depiction would have three characteristics. It should be (1) complete, (2) neutral, and (3) free from error.

The professional and ethical goal is to maximise those qualities to the extent possible. A complete depiction includes all information necessary for a user to understand the phenomenon being presented, including all necessary descriptions and explanations (IASB, 2010, QC13).

Each industry is different and may require disclosure of other numerical information and explanations. The main goal is to show the nature, the „economic substance“ of reported items and all the circumstances important for understanding current and future business performance. In many cases identifying the nature of the business, the nature of a specific business transaction can be a really complicated process.

Complex financial instruments like derivatives could be a good example. It can be an extremely complex task to recognize such an instrument and establishing its value in the

way to allow the financial statement readers' to understand the nature of this asset or liability and its possible influence on company financial condition.

A neutral depiction primarily means unbiased approach, both in selection and presentation of financial information. It means that financial information should not be prepared in the way to make a particular impression on its users.

The goal of financial reports should not be causing the favourable or unfavourable reception. For example, it is unacceptable from the ethical point of view to decrease the depreciation rates to report higher profits. Depreciation should match the way how the fixed assets contribute to entity profits but not reflect the willingness of the managers to create a positive image of the company in the financial statement.

The role of professional judgement in financial reporting procedures is still increasing. The accounting standards evolve to better reflect the complexity of modern business models and leave accountants the freedom to take into account different circumstances arising from the industry, culture or environmental conditions. On the other hand, it creates risks for financial data manipulation and the usage of freedom left by the standards setters in an intentional way.

Being free from errors means there are no mistakes or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process (AISB, 2010, QC16). It is worth mentioning that this does not necessarily mean the numerical accuracy in all respects. It is allowed to simplify or omit some details in accounting process as far as data is unessential. Moreover, as already mentioned, many estimations of risks, prices, discount rates are used in financial reporting and by the nature of these procedures we cannot speak about numerical accuracy.

The managers should be aware that when asking for a valuation, for example, the fair value of real estate, several independent experts should be prepared to support with different results. It does not have to mean that the valuations are manipulated. This may be due to accepting different assumptions in the process. It is important, however, that these assumptions should be clearly disclosed and based on professional knowledge and, as far as possible, on objective sources. It is also good practice to present the sensitivity analysis of a given project to change of the adopted assumptions.

For to prevent reporting from being biased or manipulated family members and managers can take many kinds of actions. Some research suggests (Lozano – Spence 2000, Spence 1999) that the process of communication in the area of ethical issues can depend on the company's size. In smaller companies the influence of friends, family and employees are highlighted, and the likely ineffectiveness of formal tools such as Codes and Social and Ethical Standards is suggested.

Instead, it seems that from the point of view of family enterprises the most important activities that can help minimize the risks associated with violation of ethical standards in accounting area are the following. (1) Employment of accountants who are members of local or international organizations professional bodies that have adopted codes of ethics and integrity which their members must adhere to in their practice. Professional ethics training is



nowadays an integral part of professional training certified by professional accounting organizations. (2) Establishing effective internal control procedures and employing qualified internal auditors may also promote ethical behaviour. (3) Selection and cooperation with an independent certified auditor who “understands” the company, industry and is aware of possible conflicts of interest, and (4) appointing experts with qualifications in the field of accounting and finance who are independent from the family to the supervisory board or audit committee could also increase ethical transparency.

#### 8.4. Conclusion

This chapter explored the main issues of performance management in family companies. The key groups of financial ratios like liquidity, solvency, debt, profitability return, efficiency, and market value ratios. It is worth remembering that finding a good benchmark for evaluating the company performance is also vital. Some research shows that family businesses have their specificity regarding financial measures, too. To be meaningful, financial data used in the performance management should be complete, neutral, and free of error. The family company owners can take some actions themselves to ensure the faithful presentation of company performance.

The IFRS conceptual framework considers faithful representation and relevance as the fundamental qualitative characteristics of decision useful information and performance management. Faithful representation is the higher-order construct of accounting information quality.

#### 8.5. Reflective Questions

1. Do you know the examples of accounting scandals associated with breaking the rules of business ethics?
2. Who (both inside and outside of the company) can be harmed by fraudulent financial reporting?
3. What does it mean that financial information must be complete? Can any facts or data known to managers be omitted in the financial report?
4. In the process of recruiting an accountant for a family business, does his/her professional ethical attitude matter? Why?



## UNIT 9: Business Valuation for family businesses

You need to determine the value of a business in very different situations. You need a fair estimation in case of M&As, issuing new shares (e.g. when launching an IPO or a venture capital fund joins the firm), a divorce, an inheritance, or distributing performance based premium to executives, and even deciding about to buy a share on the stock exchange. As the top management should act in the best interest of the owners, executives should always pick the strategic options delivering the highest value to shareholders. That can only be done if the organisation understands how acts and decisions would affect the value of the equity.

### 9.1. Basics of business appraisal

Theoretically, aim of a business is to maximise its shareholder's value, e.g. the wealth of the owners. Many stakeholders need to know the firm's real value. One of such parties first of all are the shareholders, and the managers who need to work every day in order to achieve the ultimate goal of shareholder value creation.

However the shareholder's primacy is the fundament of the applied business practice, most firms (except of the listed ones) do not really follow the development of their own value. The reason is quite simple: a business is sold once in a blue moon, while calculating the value could be very complex and requires special expertise.

Listed corporations are different. Because of the shares traded freely and fast on the stock exchange, investors must attempt to appreciate real share prices in order to realise highest return as possible. As transactions and exchange rates may change extremely fast, available information is to be processed immediately to make assumptions and estimations that are more appropriate.

In spite of these difficulties, estimating a listed company's equity value is quite easy, because it is equal to the actual market price of the company's shares multiplied by the existing number of shares (Barker, 2001), called capitalisation. However, to work in the interest of the shareholders on a day-by-day basis, we have to know how that share price could be derived from the expected performance of the firm. Linking the fundamentals to the value of the firm or the equity is vital for any top manager, no matter whether they work for a listed multinational or a family owned SME.

Generally, we may tell apart three different valuation approaches (Damodaran, 2012). (1) The asset based approach focuses on the current wealth of the firm and answers the question how much money we would receive if we would stop the operation and sell off all the assets or how much we would have to spend if we were to recreate the whole firm by buying everything again. (2) The income based approaches focus on the future

performance of the firm. These methods look for the present value of future gains an owner would receive assuming a given strategy and a given set of market conditions. (3) Multiple based approaches compare our firm to other companies the value of which are known, and derive the value for our entity from that. This approach quantifies the offer price we may receive if an average buyer would be willing to purchase the total of equity.

Asset based methods do not take into consideration the future business aims and do not consider the fact that the business will survive, operate, and grow in the future. By that analysis, the business is considered - as non-operating or non-functional entity - to process liquidation or voluntary cessation is already started or ongoing. In that sense, the true value can be elaborated only through the assets the firm owns and the future value income cannot be involved in the process. (Pápai, 2014, p. 5)

We have to remember that the value of a given asset may heavily depend on the conditions under which we have to sell or buy them (e.g. forced liquidation). Some intangible assets even lose their value in case of a liquidation, for example we cannot sell unused software licenses to a third party. Transaction costs, set-up expenses, costs of hiring and training people should also not be forgotten.

If you plan to operate the business, we may be better off by deriving the value from future gains. Those might be estimated by accounting profit, dividend (dividend discount models – DDMs) or far better by different kind of cash flows (DCF techniques). To do that, we need a detailed financial forecast of the balance sheets and income statements for the coming years. Usually an explicit period of 7 to 10 years is recommended, but theoretically we have to make explicit predictions of each year until we may realistically assume that the firm, the market, and the economy will not reach a long-term, stable state. If that is reached, we estimate the long-term sustainable growth rate and the corresponding financial statements and use a growing perpetuity formula to estimate the value for the rest of the business life. The result is called terminal value (TV). (Koller, Goedhart, and Wessels, 2015)

Adding the present value of gains from the explicit period and that of the terminal value will lead us to the current value of the firm or equity. To reach that, we need also to estimate the appropriate cost of capital, depending on both the risk of operation and the risk coming from leverage changing probably each year. For to have a precise estimation, this process needs a huge amount of time and information, and you have also to hire an expert with a special training in the field.

At the same time, the value of the business should reflect the market conditions. Besides, not everyone has the required skills to perform an income based. Thus, we may wish to build our valuation model on prices of similar firms already known from the market. This is something similar we do when selling an apartment. You calculate the price per square meter for similar flats, and simply multiply that by the size of your flat. We need here to overcome at least two challenges. (1) Where do we get values for similar firms? (2) What quantities shall we use to compare our firm to the rest of the market?

We may earn data of firm values from two different sources. (Damodaran, 2012) If you use market quotes from stock exchanges your data will contain a minority discount and could be affected by market mispricing like bubbles or crashes. Here, we have to hope that on average the market is right about prices, but in case of effects hitting a whole industry or economy that might not be the case at a given point in time. If you collect information from M&A transactions, you will have far less firms to compare as peers than in case of the earlier market based method, and the takeover prices will include different amount of majority premiums and synergy shared with the seller. In this case, we assume that sellers and buyer did a profound valuation and made a fair deal, there was exactly the same premium applied that we need to consider in our case.

Fair market value means the price a particular seller is willing to sell a firm at and the price a buyer is willing to pay while acting not under duress but fairness. Fair market value plays an important role in business valuation. Still, we may tell apart some other types of values, such as (1) investment value, (2) intrinsic value, (3) market value, (4) liquidation value, and (5) book value.

Investment value is closely related to fair market value. The main difference between them is that in the one hand, fair market value is a theoretical construction and based on an analysis (with its assumptions and expectations), in the other hand, investment value is the paid amount, which resulted from negotiations about the business. Consequently, investment value may contain speculative or unfair elements.

Intrinsic value concentrates on determining the value of a business based on the characteristics of the company for a theoretical "ideal" (e.g. hypothetical) investor. The result of the investigation on the intrinsic value of a business may be an appropriate price for the shares regardless of the current market price. If the intrinsic value is higher than the market price because of strong investment demand, then there is a common tendency of overvaluation. Conversely, if the intrinsic value is lower than the market price than it can cause the undervaluation of the business. Why we may need such a value is because we may not know for whom we have to find the fair value. For example analyst at brokerage firms have to issue buy and sell recommendations without exactly knowing who will read and use those reports.

The market value of a company cannot truly reflect the actual worth of a business because it is calculated from its current stock price (capitalisation) and mostly takes the role to mirror the investing market based on supply and demand.

The liquidation value focuses on the assets (not the performance) of the business with the aim to find a value for each of those independently. The calculation contains each tangible (for instance real estate, inventory, and equipment) and intangible asset (such as patents, rights) as well, but probably using different asset valuation methods with heterogeneous assumptions and precision. For example, due to the absence of a liquid market, the value of the intangible assets is usually far harder to estimate and thus also less exact. Also, we have to differentiate between two forms of liquidation processes.

(Tuller, 2008) Firstly, in case of 'forced liquidation' assets of a company have to be sold within a very short time range. Secondly, the 'orderly liquidation' of the company assets happen without a haste with carefully timing, and may last even for a year or more.

Book value is an accounting term usually referring either to the business (book value of debt and equity) as a whole or to the equity only, notably to the difference between total assets and total liabilities, including preferred stock with redemption features. This approach of value is not to be mixed with the asset valuation technique accepting the modified purchase price (book value) of accounting as a good estimation for the value of a given asset. For example, we may see someone using the book value of all assets to estimate the value of the firm (V) and then deduct the market value of debt (D) from it to estimate the total value of equity.

It is important to see that market price is objective (the same for everyone), while value is always subjective as we determine that for a given investor, under given market conditions at a specific time. The fair price always refers to any price between the value for the buyer (maximum) and the value for the seller (minimum). In the real life, it is very rare that we would need the "fair value" or "intrinsic value" for a hypothetical (idealistic) investor.

Subjective results reflect to the preferences, preconceptions and other opinions of the analysts, consultants, or investors. The analysis of the current status itself may contain subjective elements, such as expectations about effects of synergies or other key elements. Then, the financial plan should reflect the aims and options of the party whose value we look for.

Valuation is not about future telling. Still, no matter how well we made our valuation, there are some unknowns, which can not be exactly forecasted. Damodaran (2012) mentions the followings:

- estimation uncertainty,
- firm-specific uncertainty,
- macroeconomic uncertainty.

Due to these, even an exact valuation will end up only with a likely range of the fair value. As the world changes, so do markets, investors, possibilities and limitations. Thus, the value itself will also change over time.

## 9.2. The process of valuation

Although not every company is listed and so you cannot trade with their shares, there are still a number of situations, when we need to prepare and appraisal for other businesses as well. Some example are

- privatisation,
- selling/buying a business (or a part of it),
- initial public offering (IPO),
- issuing new equity,
- estate planning and gifts to heirs,
- tax issues,
- other, family related issues (for example divorce, inheritance),
- determining bonuses for the top management,
- choosing among strategic options.

Initial public offering (IPO) means that the open public can purchase the company's shares on the stock exchange for the first time. Before an IPO, company must establish a number of different documents to convince potential investors that shares are worth buying at the pre-set price. These papers offer a lot of information about the company and about its prospects, based on which investors attempt to set the appropriate price of the shares themselves.

If the estimated value of the share is higher than the offer price, they will buy it, in the other case, they will not. That is why to assure the success of an IPO, former owners may agree to offer the new shares with discount (at lower price than the estimated intrinsic value). In case of an IPO, players have different interests.

If an investment bank acts as underwriter, they have to buy all shares not sold in the IPO. Thus, their interest is to set a low price, because it reduces the risk that they will not able to sell all the shares. In addition, even if they have to buy, when later the price increases, the bank can realise a profit by selling those shares later.

Interest of present owners is to sell shares at a high share price. If the IPO is not only about issuing new shares, rather old owners sell off some of their own stake they may be interested in overestimating the future economic outlook of the company, to influence expectations and boost the current selling price.

At the same time, investors seek a good deal, e.g. a (less than) fair offer price and great outlooks. Due to this, if a relatively unknown company wants to start as a success story on the stock exchange, it is often advised to offer shares at IPO with a discount of 15-20 percent at least.

### 9.2.1. Business valuation process

Business valuation is a process consist of the following steps (Damodaran, 2012):

- (1) determining what (company, equity, share package, a single stock), why, for whom and what date we have to find the value for,
- (2) choosing the proper valuation method(s),
- (3) data collection, analysis and predictions,
- (4) performing the valuation,
- (5) checking the results.

According to the given situation, we pick the proper valuation method. It may be useful to use several methods in order to have a more reliable result. But we have always to keep in mind, that the three different approaches answer different questions, so we should never ever calculate the average of the values estimated using different methods. Recall that income based methods determine the value once the firm is run by a given investor following a given strategy. Multiples estimate the value we would receive from an "average" investor, if we were to sell the firm. At the same time, asset based methods assume the liquidation of the assets. It is clear that we can not do all these three at the same time, so an average would be meaningless.

### 9.2.2. How to read the results?

Let us see an example. Assume that an owner of a family business considers to retire, and wishes to estimate the value of her business. Income based method would assume the continuous operation of the company what is only realistic if she hires someone to replace her as top manager. This is why we have to create a financial plan for the coming 7-10 years describing the expected performance of the company when lead by an average manager hired from the market. Probably this will imply a lower than historical performance (the manager may not be as committed as the owner herself was) and a higher personal expense if the owner did not require a market-level wage for her contribution until now. Thus, we end up with a value for equity (E) of 600 million HUF. At the same time, we may consider the market valuation of our near competitors. We have to look for peers with similar risk, future growth opportunity, and cash flow generation capability. (Damodaran, 2012) We pick some multiples, like P/E or EV/EBITDA and figure out that the fair value of equity might be 700 million HUF.

Finally, considering all the assets the company have we could get 800 million HUF by selling them all and paying for all the liabilities. What could be the fair value for the owner? Of course, the owner wishes to receive as much money as possible. It seems, that the best solution is to liquidate the company ( $800 > 700 > 600$ ). But before recommending that, we should double check whether there are assets held by this company that are not needed for the future operation anyway. Assume, that there is a huge empty real estate just next to our main production site. We bought that several years ago to be able to expand our activities, if necessary. Currently, our employees use it as a parking lot. It is clear that the value of this unneeded asset could not be included in the result of the income or multiple based method. If the value of this real estate is 150 million HUF, we have to add that to the results of these methods, as the real estate can be sold any time and the operating value of the business is still unchanged.

Thus, now the multiple based value is the highest. To realise that, we have to sell the company to an average investor, who is estimated to pay this price. Before advertising the firm for sale we might probably check whether peers in multiple based are not currently overvalued at the market, in other words whether our multiple based estimate holds until we find a buyer. In addition, we should review the DCF model. Is it sure that efficiency will fall by that extent? Are there no positive effects?

Finally, we have to note that it is only possible to sell the company after hiring a professional manager, as the owner will go to pension anyway. Did we modify current financial numbers (EPS for P/E, and EBITDA for EV/EBITDA) to reflect estimated effects of succession? If not, we have to re-estimate the multiple based value.

At the end, it is the job of the current owner to determine what should happen. As we will see in Chapter 11 very often it is not the income received that is the most important for the owners when deciding about how to exit the family business. No matter what the

final decision would be, it is for sure that the average of the results of the different valuation approaches is worthless.

A business valuation usually starts with the collection of the necessary information about the given company. These could include

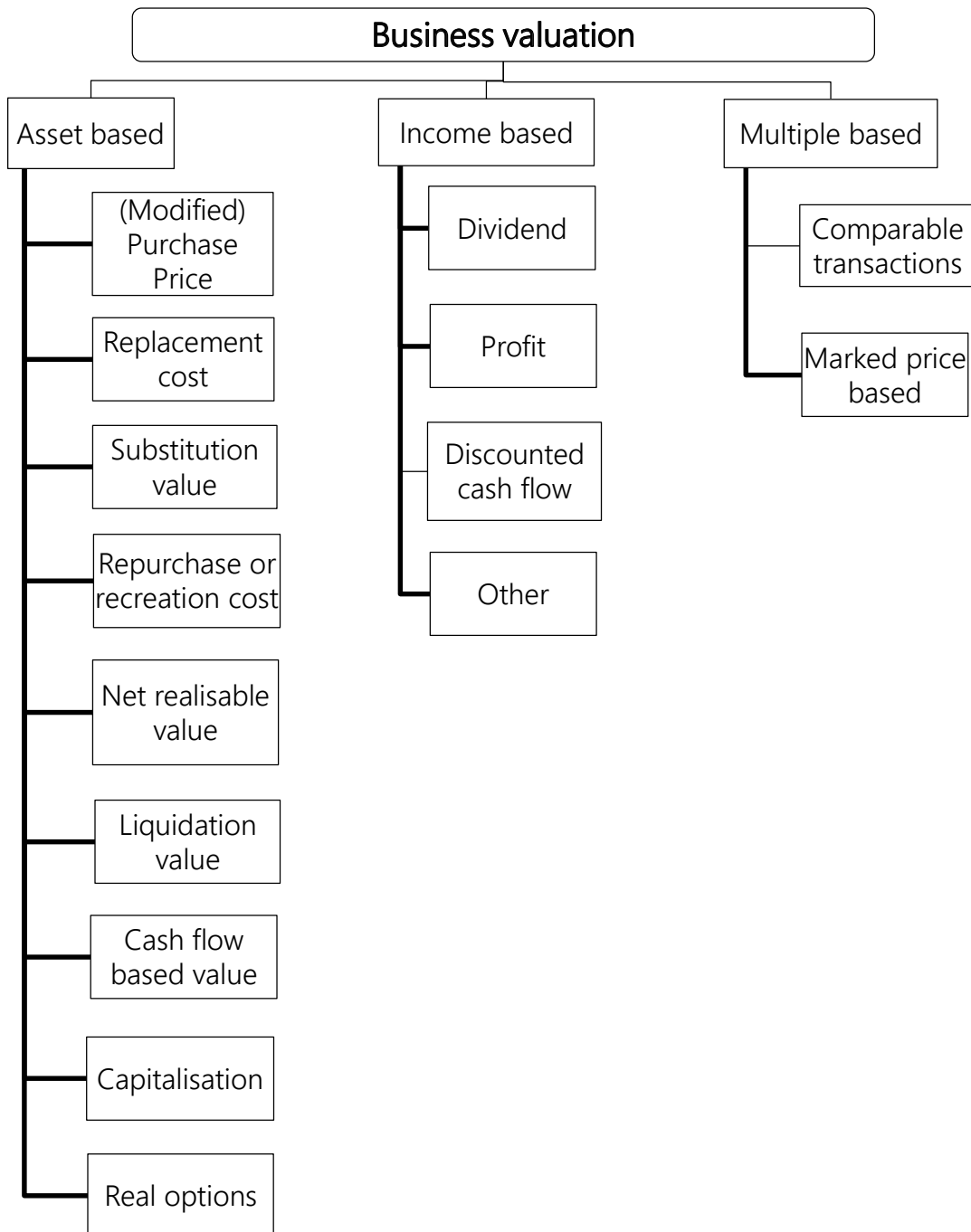
- historical financial statements (of the firm in question and those of the competitors),
- macroeconomic predictions (GDP growth, inflation, yield curve, market premium, unemployment, demographic and market demand trends)
- customer lists, vendor lists,
- tax returns,
- strategy,
- articles of organization/incorporation,
- bio of the top management,
- stock market data (prognoses, share prices, multiples).

As a start, it is very useful to conduct analysis about company's business environment as well as a comprehensive financial analysis of the company (Ballard, 2014).

While it could seem logical that a valuation relying on a more detailed prediction would be more exact, this is not always the case. (Damodaran, 2012) If it takes one hundred variables to estimate the value, we may commit errors during all those estimations. Once we have just very limited information, we may be better off by using a more simple model estimating just 20 variables and assess those inputs more exactly.



Figure 1 Business valuation methods



### 9.3. Business valuation methods

There are many valuation methods. They differ in precision, time, data and calculation need, and, as we have seen in the previous part, in the question that they seek answer for. The following short review aim to give an insight to the complexity of the valuation process.

#### 9.3.1. Asset-based methods

Asset-based methods use the principle that the value of the business is based on the value of the assets owned. Because the shareholders own the business, they own the business' net assets as well. (Net assets refer to the difference between total assets and outstanding liabilities.) There are a number of different ways to estimate the value of an asset each of them requiring different data and assumptions and leading to different results at the same time. (Koller, Goedhart, and Wessels, 2015; Juhász, 2004)

Modified purchase price. Any assets is worth the amount we were ready to pay for it. Of course, since then we may have used it or we could upgrade it some way. So when starting from the original price we modify it in accordance with historical events. The book value of accounting is a good example for this.

Replacement cost refers to the possible cost that would emerge if we were to repurchase exactly the same asset today in its current state. (So a used car is replaced by a car of the same age, type, specification.) Substitution cost considers all the functions of the asset we are using and looks for any asset that may offer us the same functions. (An old office building may be substituted even by renting some space in a new building.)

Repurchase cost covers the purchase cost of a new item. The company itself may be able to produce some assets (e.g. finished product inventory), so we may estimate a recreation cost instead.

Net realisable value estimates the amount of money received if the item was sold. The word net refers to the transaction costs and taxes deducted. Liquidation value is similar to this, but we assume a forced sale under within a short time frame.

Cash flow based value required us to predict future cash flows of the asset and calculate the present value of that. Sometimes the asset itself does not generate a positive cash flow but by owning it, we may save future expenditures. (E.g. an own office building used by the firm generates expenditures only but it also saves us from paying a rental fee somewhere else.)

Capitalisation is a kind of multiple based method. We usually look for the net income generated by similar assets and compare that to the market value of the given asset. This ratio (called capitalisation rate) is then used to divide the expected net income of our asset to get the market value estimate.

Real option model calculates likelihood and payoffs of probable future situation to include flexibility within the asset into the value. We have to be very careful when using results from this model as here higher risk may go hand in hand with higher value. That is why often poorly performing, high risk (and so negative NPV) projects (assets) are offered as real options.

### 9.3.2. Income based models

Income based models build on some kind of net inflow of the company or the shareholder. The theoretically best founded are the discounted cash flow models which are based on the assumption that a group of assets (i.e. the firm) is worth as much, as discounted value of the expected future cash flows that those generate. To predict future performance usually a complex financial model is set up using various spreadsheets. After calculating future cash flows, we have to determine the discount rate that reflects the risks for getting these cash flows of the expected amount on time. Calculating a proper discount rate is crucial, because a small change in these rates might lead to a huge fall or increase in the business value.

When setting the required rate of return, we always have to consider for whom we do the valuation. A well-diversified international strategic investor may use a far lower rate than a family owner who has most of her wealth inside this one single company. The total firm value can be calculated as follows:

$$Firm\ value = \sum_1^t \frac{Cash\ flow_t}{(1 + discount\ rate_t)^t} + Residual\ value$$

The most well-known DCF method is the free cash flow to firm (FCFF) technique which discounts the cash flow of the firm without considering any effect of financing by the weighted average cost of capital (WACC). WACC is a cost of capital that is modified to include not only the cost of capital but also the tax shield effect of the interest payment. (As FCFF contains no financing effects, it has too high tax deduction included because the tax base has no interest deducted. The corporate tax that we do not have to pay because of the interest payment is called tax shield.) The formulas to determine the value of the firm (V) and then that of the equity (E) are the following.

$$V_0 = \sum_{i=1}^n \frac{FCFF_i}{\prod_{j=1}^i (1 + WACC_j)} + \frac{TV_n}{\prod_{j=1}^n (1 + WACC_j)}$$

$$TV_n = \frac{FCFF_{n+1}}{(WACC_{n+1} - g_{n+1})}$$

$$WACC = \frac{D}{V} r_D + \frac{E}{V} r_E$$

$$E_0 = V_0 - D_0$$

where  $r_D$  is the cost of debt,  $r_E$  is the required rate of return of equity,  $D$  is the market value of debt,  $g$  is the long-term growth rate.

While there are several DCF methods, you have to be aware of the fact, that those all should lead to the same numerical result if performed correctly. (This is not true for the different asset based and multiple based techniques.)

Another widely used income based method is the dividend discount model, where you only have to predict the dividends that owners may collect in the future. Then using the following formulas you can get quickly the value of equity. This approach assumes, though, that you have a minority package, which does not make it possible for you to influence the future performance of the company.

$$E_0 = \sum_{i=1}^n \frac{DIV_i}{\prod_{j=1}^i (1 + r_{Ej})} + \frac{TV_{En}}{\prod_{j=1}^n (1 + r_{Ej})}$$

$$TV_{En} = \frac{DIV_{n+1}}{(r_{En+1} - g_{n+1})}$$

### 9.3.3. Multiple based models

Multiples compare our firm to other the value of which is already known. We may take these values from earlier transactions (comparable transaction based method) or from current quotes on a stock exchange (market based method). Based on Damodaran (2012, Chapter 17-20) we have to tell apart four types of multiples:

- (1) Earnings multiples (P/E, EV/EBITDA),
- (2) Book value multiples (P/BV, EV/BV),
- (3) Revenue multiples (P/S, EV/Sales), and
- (4) Sector-specific multiples (EV/square metre, EV/subscribers).

These do not only differ in the denominator of the ratios, but also, on how you have to handpick the comparable firms that could serve as peers. Just calculating the average ratio values for all the competitors and using those values for to multiply our firm's denominator is a typical mistake to evade.

The basic requirement is that all peers have similar risk (both operational and financing), growth, and cash flow generation capability. It is key to recall that (1) not all competitors can be used as a comparable, (2) a company that is a good peer for one ratios, could be prohibited to use for another ratio, (3) peers may come from a totally different industry.

#### 9.3.4. Discounts and premiums

The value that results from the earlier valuation methods may not be right, due special characteristics of the business, which were not taken into consideration during the modelling and calculations. Therefore, we use discounts and premiums, which modify the value derived earlier. Discounts and premiums are often subjective elements; but their amount may vary only in a specific range that could be quantified based on earlier experience or court decisions.

We have to differentiate between discounts and premiums on the whole equity affecting all the company and those valid only for a given package of shares or one single stock. Typical discounts and premiums (P&D) for the total of equity include the following (Pratt, 2009):

- key person discount (for hard to replace key individuals)
- liquidity discount (for firms with payment problems)
- discount due to lack of synergy across business units (diversified activities distract management attention)
- discounts due to off-balance sheet or expected liabilities (ongoing litigations, changing regulations).

P&Ds often used for a specific package:

- minority discount (little or no influence) / controlling premium (for package offering significant influence)
- liquidity discount for shares being hard to sell (minority stake in a non-public firm)
- premium for preference in voting or dividend
- discount on huge packages (sales of the package would considerably influence the market price).

As minority shareholders have little voting power and limited control of the firm, a 20 percent stake in a company has a value that is less than 20 percent of the total equity value. Conversely, an 80 percent share should be worth more than 80 percent of the full value of the company. This premium is called also as controlling premium. We should take care that the total of all the stakes after applying these premiums and discounts still should add up to the total of equity, as control over the firm is a zero sum game.

Key person discount is common in case of family business. Many of those firms rely on one single person as a non-replaceable top manager while non-family businesses usually share and divide decision-making rights over several employees. This means that a non-family business is less dependent and vulnerable if something would happen to the decision maker. This is not only a threat when the owner-manager turns ill or is hit by an accident, but creates a continuous danger as decisions are based only on the skills, abilities, and knowledge of a single individual instead on that of a wider group. Many enterprises “may not be worth as much as the owners think, simply because their companies do not follow best practices for their industry, nor are their finances or business strategy in the best of shape” (Holton & Bates, 2009, p. 170).

#### 9.4. Specialities of family business valuation

There are various specialities of valuation mentioned in the literature. These include among others concentrated ownership, family ownership, founder-manager effect, structured ownership and separation of personal goodwill.

In case of family-owned firms we always face a concentrated ownership. If the majority of the shares is held by a single entity or a closely related group than we expect a strong control over the management and an intense focus shareholder value creation that increases the stock price even for non-family members. At the same time, concentrated ownership may offer the possibility to the majority owner to divert some of the income belonging to minority owners to his own advantage. This is why it is not straightforward how concentrated ownership influences the stock price reflecting value for minority shareholders. Earlier estimates ended up with a discount of 5 to 10.5 percent on minority stakes due to concentrated ownership. (Villalonga and Amit, 2006)

Villalonga and Amit (2006) examined Fortune 500 firms during 1994–2000 to identify any value effect of family ownership. They concluded that just family ownership itself did not generate value, but the founder serving as a CEO or as chairperson if a non-family member CEO were hired, added significant value compared to nonfamily firms. This calls for applying a 25 percent founder-manager premium in case of these companies based on their estimation. That means that this positive effect more than counterbalances the negative effect of concentrated ownership.

Still, this positive effect is only valid for the first generation. They also found that any shareholder-CEO conflict is more costly for companies with a descendant-CEO than in nonfamily firms, in other words such an employment rather destroys value.

Baek and Kim (2015) emphasises that the positive founder effect of family businesses is only statistically significant for the firms with a cofounder involved. They analysed more than 17 thousand US companies for the period 1996–2010. They argue that the positive effect is due to the cofounder reducing the key person risk offering a replacement for the founder and is mitigating the negative effect of concentrated ownership. Based on this the additional coordination costs raised by several founders are more than counterbalanced by these positive effects.

The effect of family ownership seems not to be positive at all times. Lins, Volpin, and Wagner (2013) studied 8500 firms in 35 countries for the years 2008–2009 to see how family control affects valuation. Based on their results, family business underperformed other companies during the financial crises and cut back more on investments than those. The higher the underperformance was, the higher the cuts on investments were. They also concluded that liquidity shocks are more likely to be passed over within the group in case of family-owned businesses.

They argue that families owning businesses tend to be under-diversified and this may jeopardise the survival of the enterprises during hard and liquidity demanding periods. Actions to save the company and thus the family wealth and to keep the company under family control, often imply management decisions that reduce value for minority shareholders. Due to that, the costs of family ownership outweigh the benefits of it during crisis times.

Techniques that reduce the control rights of the non-family member owners (e.g. dual share classes, pyramids, and voting agreements) had negative effect on the share price. So, we have to be aware of the possible existence of a ownership structure discount. (Villalonga and Amit, 2006)

Reilly (2016) emphasise the importance of telling apart the personal goodwill of the entrepreneur from that of the firm itself when valuing a family business. This might be important in the various (gift, estate, transfer, income) tax issues that might emerge. That means that in most cases when we perform an appraisal for a family-owned company we do not only have to calculate the total value of the firm ( $V$ ) and the equity ( $E$ ), but also have to quantify what is the part of the current value that is attributable to the current individual owning the entity. This later value could be lost completely when a new owner takes the firm over.

Of course, losing this personally owned goodwill would be a serious problem so new owners might try to keep as much of it as possible. Nevertheless, if those were transferable, the taxation could be completely different. If the shares were held by a family-owned wealth management company or the sale of the firm would be structured as an asset sale (instead of sales of shares), any income would be taxed first by corporate income tax then by personal income tax of the owner. At the same time, personal goodwill (and any assets owned personally like a brand name) sold would only be taxed under the personal income scheme.

Personal connections seem to have a very high importance for family controlled business, and investors seem to consider that. Bunkanwanicha, Fan, and Wiwattanakantang (2013) investigated the value effect of a marriage in the controlling family for listed companies in Thailand during 1991–2006. They found a significant positive effect only for the cases where the partner is from a significant business or political family. This effect is bigger for the firms the operation of which depends heavily on extensive networks.

Marriage to other (“ordinary”) people had no significant value effect. This later result is important because earlier papers assumed a positive effect of any marriages as those enhance the chance of finding a worthy successor later by bringing into the firm a talented daughter or son in law.

#### 9.4.1. Hotel Pilot

János Kiss was always a fun of aviation. He used to spend hours at the airport with his father looking at planes taking off and landing. With 25, he was already a successful aerobat, and soon he became a flight instructor. He was 45 when he inherited a considerable sum and decided to start a family business. After renovating and extending the family house of his father located in the centre of one of the biggest Hungarian cities, together with his wife he opened the three star Hotel Pilot full with aeronautical decorations. Today, 22 years later, at the end of 2017, Mr. Kiss is about to retire to spend more time with his grandchildren one of whom is a fun of aviation photography.

Edit (41), the daughter of Mr. Kiss, has been working with the firm for 15 years by now, and step-by-step she took over the CEO position. The son of Mr. Kiss, Balázs (35), is living and working at a multinational company in the capital, Budapest, some 200 kilometres away. To sort out any possible inheritance problems, Mr. Kiss hired a specialist to determine the value of the hotel.

The specialist interviewed all active family members and key employees, and talked to industry specialist to figure out about the outlook of the business. Based on that and the historical efficiency data, an integrated financial model was set up the result of which are summarised in Table 1.



Table 1 DCF valuation of Pilot Hotel equity

Million HUF	2018	2019	2020	2021	2022	TV
Sales	65,00	67,00	68,50	70,30	71,00	73,00
Expenditures	51,10	51,50	51,60	52,20	51,90	53,30
D&A	3,90	4,00	4,20	4,30	4,20	4,50
EBIT	10,00	11,50	12,70	13,80	14,90	15,20
Noplat	9,00	10,35	11,43	12,42	13,41	13,68
$\Delta$ WC	0,50	0,55	0,61	6,66	0,71	0,74
$\Delta$ Invested Assets	3,00	2,50	6,50	2,90	4,20	4,50
FCFF	5,50	7,30	4,32	2,86	8,50	8,44
Interest	0,00	0,00	0,00	0,00	0,00	0,00
Tax Shield	0,00	0,00	0,00	0,00	0,00	0,00
$\Delta$ Debt	0,00	0,00	0,00	0,00	0,00	0,00
FCFE	5,50	7,30	4,32	2,86	8,50	8,44
Long-term growth						5,00%
$r_f$ forward	0,05%	0,42%	1,22%	1,88%	2,33%	3,50%
Market risk premium	8,40%	8,20%	8,00%	7,80%	7,60%	7,50%
$\beta_A$	0,74	0,74	0,74	0,74	0,74	0,74
$r_A$ forward	6,22%	6,49%	7,14%	7,65%	7,95%	8,15%
D/V	0,00%	0,00%	0,00%	0,00%	0,00%	0,00%
$r_E$ forward	6,22%	6,49%	7,14%	7,65%	7,95%	8,15%
E beginning of year	213,42	221,18	228,24	240,21	255,72	267,55

As next step, the consultant estimated the cost of capital of the firm using the CAPM model. As the family insisted on not using any foreign capital, no leverage was assumed. Industry beta estimation was derived from the online database of the American professor Aswath Damodaran (2017). Market risk premium estimate came from the survey of the Spanish professor Pablo Fernandez (2017). To find the risk free rate, the specialist used the yield curve estimated by the Hungarian Government Debt Management Agency (AKK, 2017). Long-term growth rate of 5 percent for the terminal value period was set in line with the long-term inflation prediction (3%) of the Hungarian National Bank (MNB, 2017) and the analyst consensus of 2% GDP real growth rate.

Multiples were derived also from the Damodaran database. Because the firm had no leverage, that is very different to the industry standard, only firm level multiples could be used. The EV/EBITDA amounted to 14,5, EV/Sales was 3. Thus, by a simple multiplication value of  $14,5 \cdot (10,0 + 3,9) = 201,55$  and  $3 \cdot 65 = 195$  million HUF were calculated.

The asset based approach was only carried out as a control. Rough estimation of the total market value of assets amounted to 113 million, so it was clear that the company should not be liquidated.

To get the final equity value estimate, discounts and premiums were considered. In case of the DCF model, CAPM assumes well diversified investors what is not the case for the Kiss family. Also, smaller firms tend to be more risky than the average, so required rate of return is higher. Thus, discounts due to small size (20%) and poor diversification (15%) were applied.

In case of the multiples, beside of firm size discount (20%) and diversification (15%), the minority discount that is apparent in stock prices should be removed. To do so a "premium" due to the majority ownership (15%) was added. Final value estimates are presented in Table 2.

Table 2 Total equity value estimates for Pilot Hotel (Million HUF, start of 2018)

	FCFE		EV/EBITDA	EV/Sales
DCF model	213,42	Multiple based	201,55	195,00
Size	-20%	Size	-20%	-20%
Diversification	-15%	Diversification	-15%	-15%
Final estimate	145,12	100% ownership	+15%	+15%
		Final estimate	157,61	152,49

Based on these numbers, the final estimate of the specialist on the total equity value was 140-160 million HUF.

1. What other factors could be considered when valuing Hotel Pilot?
2. Propose solutions supported by calculations to compensate Balázs for Edit inheriting the family business.

## 9.5. Conclusion

You may need the value of your business in various cases. Even if you do not intend to sell, it is vital for the organisation to have a good understanding of the shareholder value generation, as executives should choose among strategic options based on their effect on the business value.

As we have seen, value is subjective and it could vary among different parties, for different points in time, or depending on the purpose of the valuation. The three valuation approaches (income based, multiple based, asset based) seek answer for different questions, thus their results should be contrasted, but never averaged.

Business valuation is a complex financial task that calls for assistance from a professional expert. However, valuing family businesses could be even challenging for them because of the specialities that we might face in addition. It seems that we may need various

addition discounts and premiums, and consider events and circumstances that otherwise would be neglected. Examples include which generation the family-owner belongs to, whether there are cofounders, what part of the total value is originating from goodwill owned by the owner rather than the company, and even, whether the family members marry the right person.

### 9.6. Reflective Questions

1. Contrast the most common business valuation techniques. What are the pros and cons of them?
2. Why is the value of a company subjective?
3. When is it appropriate to use discounts and premium?
4. List the key specialities of family business valuation.

## UNIT 10: Leaving the company

Like the lyrics of lyric Guns 'n' Roses says "nothing lasts forever, even cold November rain" and that is true also for the ownership in a family business. People grow old, turn ill, have to look for a more profitable job, can have disputes with other owner or simply lost their interest in the business. But also changes in regulation, taxation or technology, and requirement of huge capital increase may force owners to stop the business or pass it on to someone else. This chapter reviews special issues of owners leaving a family business.

### 10.1. Ways to say goodbye

If the owner-manager leaves the family business that creates a shock for the entire organisation. But the huge change has not be without advantages: a well performed change management may help to take the most profit out of the situation.

So how can we leave the family business? Different techniques raise heterogeneous challenges that need to be dealt with. It is vital to tell apart leaving the top management, the ownership position or both of them.

- (1) Liquidation. The worst case is when the firm has to cancel its operation. If the company does not survive a given situation, owners and managers have both to leave. In such cases all valuables of the company has to be sold, liabilities repaid, and any remaining capital would be distributed among owners. The business will stop existing legally.
- (2) Family succession. This general name usually cover passing over both ownership and management position to the next generation in the owner's family. While details will be covered in more depth in Chapter 13 we have to see that it is not necessary to choose a family member as a successor for top manager, and there is no obligation that a founder going into pension would not only hand over her (his) seat to the selected heir but also the ownership rights. Also, even if both of these acts are planned, those do not have to happen at the same time.
- (3) Management buy-in. In this case the current (non-family member) executive(s) purchase a stake of ownership.
- (4) Management buy-out. Current top manager(s) buy all the shares of the former owner to gain complete control over the company.

- (5) Selling the firm to outsiders. Both other entrepreneurs and private equity fund may be interested in buying the majority stake of a private company. For a successful transaction usually we have to assure an ongoing top-management who might be replaced later on. Payments usually follow a certain schedule and it can take several years until the owner receives the total selling price. This could be a good solution when no family member is willing to have a career within the company. The money received is easy to distribute or reinvest into another company.
- (6) Franchising and licencing. In these cases the company would allow other firms to use its technology, brand, strategy and will receive a regular fee payment in exchange. These methods make it possible for the current owner to reduce management burden, as (s)he may stop the current business activity even completely and focus only on managing the licencing contracts. Theoretically it is possible to liquidate the original company but typically to legal and tax reasons owner usually keep fee income within the old firm that might cut back its activity to the basic administration.

Though, franchising and licensing does not have to do anything with leaving the business: many owners see those as an option to extend their economic power by allowing other to use their knowledge. This can help to let the brand grow and take part of the addition profit while not having to finance or manage the growth itself.

(7) Joint ventures. Creating a shared business with another enterprise may reduce the burden of everyday work. If most of the business activities would be moved to the new company risk and profit could be shared and the former family business owner may turn into a passive owner and enjoy pension.

(8) Merger. If you merge your firm with another one that has stable management, you may become a passive owner. Still, to keep your interests protected you may see it advantageous to have at least one board member in the new company delegated by you.

(9) Initial Public Offering. IPO is the act when the shares of a company are first offered to the public. Typically this step will be followed by introducing the shares to a stock exchange. IPO may offer a way to get fresh capital (newly issued shares are sold to the public), may decrease the owner's investment (existing shares are offered by the founder for sale), or both. While theoretically possible, it is not realistic for an owner to completely to leave a company by an IPO as the potential investors may not welcome shares the former owner her(him)self do not trust anymore. But once the firm being listed it may be far easier later to sell the remaining package of the owner.

No matter which method we pick, it may be wise anyway to separate management succession from passing over ownership well on time. The key reasons are as follows.

(1) This step makes it possible to separate the timing of the two acts offering more flexibility. The owner may correct her (his) decision later if the successor for top manager does not prove to be a good choice.

(2) While usually there should be only one person leading a company, ownership rights are theoretically endlessly dividable. While the family member chosen to be the top manager may wish to have a majority stake, the remainder could be distributed freely among the rest of the family easing the burden of estate planning.

(3) Shares of firms that do not need active involvement of the owners are easier to pass over. Thus even if you wish to leave the total ownership to your heirs the value of that inheritance could be higher if an independent professional management is overlooking the company.

## 10.2. Why would you leave?

Poor business performance, difficulty to finance the company, getting a great job offer, turning ill or old, getting married or divorced, sudden need of a big amount of money, appearance of a generous buyer, getting bored by the everyday routine of a company that after a long and exiting growth period started to slow down – these are just some of the motivations why funders may decide to leave their company. The willingness to exit may depend on a number of psychological factors. Salvato, Chirico, and Sharma (2010) call the attention to the additional exit barriers family firms present. They underline that the family member manager tends to see her(him)self as a steward of the family wealth. Due to this, when experiencing declining performance, they feel guilty and want to regain the loss. They may even feel ashamed to sell and exit. This is why owner-managers of top performing family business are more likely to exit.

Once the decision to leave has been taken, we may have various aims for doing so. DeTienne, McKelvie, and Chandler (2015) propose to set up three categories for motives to exit. These are the following.

- (1) Financial harvest. The result of these exits through IPOs or sales to other companies is high monetary return to the former owner.
- (2) Stewardship. These exits have as main aim the smooth ongoing operation of the firm through family succession, employee buy-out or sale to another individual.
- (3) Voluntary cessation. The key common trait of these exits is that owners disband the firms (liquidation, discontinuance).

Table 1 Typology of exit strategies

	Financial harvest	Stewardship	Voluntary cessation
Owners			
Age	Younger due to lower opportunity costs		
Education	More education	Less education	
External rewards	Motivated by financial reward or to create a profitable firm	Less motivated by financial reward	
Desire for autonomy		Strong desire to be independent and retain control of the company	
Firms			
Size of founding team	Larger	Smaller	Self-employed individual
Innovativeness	More innovative		Less innovative
Size of firm	Focus on efficiency, less employees	Focus on people, more employees	Focus on income-substitution (lifestyle), less employees
Start-up decisions			
Causation-based decision process	Planning based approach		Less likely to perform long-term planning

Source: Based on DeTienne, McKelvie, and Chandler (2015, p. 260)

The way owners tend to exit depends among others on individual traits. DeTienne, McKelvie, and Chandler (2015) call the attention to earlier research results based on which more experienced owner were more likely to be involved in M&A transactions and IPOs, but less likely performed a liquidation or an independent sale. Entrepreneurial education was positively linked to IPOs and acquisitions; but negatively related to family succession. Besides, recent research shows that good personal connection particularly to family members are vital for staying in business. Analysing 388 married US family business owners Hsu et al. (2016) concluded that interference between business and family life are one of the key motivations for owners to leave their company. This process is significant for both directions: difficulties in business making family life harder and problems at home hindering business both are strong motivators for exit. This kind of pressure was significantly stronger in case of women than men. At the same time any positive effect of the business on the family life (connections, resources) reduced willingness to exit.

Very similar findings came to light for immigrants. Bird and Wennberg (2016) investigated family business of immigrants in Sweden. They showed that family ties offer a great help to immigrants with the successful integration into the economy. The geographical proximity of relatives promotes the willingness to stay in the business, while the high amount of resources (e.g. information, network, knowledge) received from family members decreases the chance of stopping the business and leaving for unemployment. Salvato, Chirico, and Sharma (2010) came to a similar conclusion based on earlier case studies in the literature. Historical experience on hard times ending sooner or later, and family legends on successful turnovers after difficulties in the past reduce the willingness of the owners to exit.

Even when leaving, it does matter to the former shareholder what will happen to the firm and who will have the control over it. Kreer et al. (2015) emphasise the importance of personal and professional networks when deciding about the best way to exit. Their research build on German family-owned SMEs showed that selling a family business to a private equity fund depends on a very complex decision process. These funds are usually believed to have short term focus and to use extensive lay-offs to reach profit targets. Owners' subjective drivers on such a sale heavily depend on the judgement of those next to the entrepreneur (advisers, layers, friends, business partners). Family-members play a very important role in the process as these family business are seen to keep some kind of social capital for the whole family, not for the manager-owner only.

Family business IPOs have their own characteristics too. As these transactions aim usually at collecting fresh capital while keeping the family control (but opening the opportunity of an easier exit for later), pricing may not target at maximum income.

Yu and Zheng (2012) analysed family business IPOs in the Hong Kong stock exchange. They found that stronger family involvement attracts more subscription to the shares of the family business. Companies with weaker involvement tend to see their family ownership reduced faster than firms with more family member working for them. During IPOs under-pricing is used to decrease outside block holdings. (Low price attracts more small investors and shares are distributed evenly, so one investors regardless of her (his) original intention would only receive just a few pieces. Thus, no considerable voting power could be accumulated.)

Business with family trusts as owners have less under-pricing proving that the two are used as substitutes to assure family control over the long run. This shows that even when scarifying a part of their ownership families focus on keeping the most the control even at the cost of transferring some of their wealth through under-pricing to the new but very weak fellow owners.

Cirillo, Romano, and Ardovino (2015) examined whether family ownership would boost IPO price. Based on a sample of 113 Italian firms from eth years 2000 to 2011 they concluded that (similarly to the Hong Kong results) family ownership increase the value, and this effect is getting stronger with more extensive business involvement of the given family. This positive effect is mainly attributable to the first generation (founders), though,



later generations in control position seem not to provide added value for the IPO market. Due to this, IPO may be a good option for founders aiming at Financial harvest, but it might not be the best exit strategy for latter generations.

Niedermeyer, Jaskiewicz, and Klein (2010) call the attention to the fact that family's evaluation of a business sale takes longer and is often very different to that of non-family businesses. Based on earlier papers, they emphasise that the sale of a family-business may be the start of something new and should not be considered as a failure. Children may start their own business in a different industry, or the same owner-manager may find a better opportunity somewhere else.

In case of sales families tend to consider factors like the culture and the identity of the firm or the identity and the reputation of the family itself – something that is not typical for the acquisition of other companies. Even after sales, families may have difficulties to let the firm go. This is why they argue that there are five factors explain satisfaction of families after a business sale. These factors are the following.

(1) Process of the decision making. Family disputes or an unexpected transaction changing the life of eth family members radically can lead to lower level of happiness.

(2) Process of the sales. Fast, smooth, and fair transaction process considering the needs and interests of all family members may contribute radically to the satisfaction.

(3) Realised sales price. Price is only one of the factors, and very often not even the most important one. We should not only consider the amount paid but also the timing of it, the transaction costs emerged, and the distribution of the income among family members with ownership rights. The amount received is more important if family is need of money and less pronounce if all members are well off.

(4) Remaining interest and influence after sales. In case the first three factors give an acceptable level of satisfaction, lower level of interest could be enough to reach happiness. But, if only limited satisfaction was gained, families may seek to have a stronger control over the sold firm. Thus to achieve the same level of happiness they need to keep more influence.

(5) Family identity after sale. Serious deterioration of the social capital may affect satisfaction so negatively that the mere fear of that could block the whole transaction. Families owning various businesses will also take into consideration the effect of sales on the value and goodwill of their other firms.

The first three of these factors are linked directly to initial satisfaction, which all together with factors 4 and 5 explain the retrospective satisfaction of the family.

### 10.3. Conclusion

It is wise to separate ownership and top management even if it is currently the same individual in both of those positions. Most ways of leaving the company need this separation for a smooth transition. Still, selling a family business can be very different compared to a sale of a non-family company. The satisfaction gained depends on several non-monetary factors, some of which are at least as important as the price itself.

Three main exit strategies (Financial harvest, Stewardship, and Voluntary cessation) were identified. It depends not only on the personality of the owner, but also on her (his) personal (both family and business) connections, which way (s)he prefers to leave. Usually families care more for the future of their companies even after the exit and fears from negative effect on the social wealth and remaining investments of the family may jeopardise the success.

### 10.4. Reflective Questions

1. Describe and contrast available exit possibilities for a family business owners.
2. What factors influence the preference of the owner regarding the exit strategies available?
3. Should an owner care for the future of the company (s)he sold?
4. Would you prefer a family business IPO over a non-family business IPO? Why?

## SECTION II: Personal finance

So you think, you have seen it all? If we were speaking about big corporations owned by institutional investors like investment banks, insurance companies, or multinational groups from the same industry active in the whole world, probably we would have come to end our book here. But family business are owned by individuals, who have their personal life, dreams, worries and fears, and whose life unlike that of institutions will for sure end on one day.

Owning a family business usually means that the future of your company is strongly linked to that of your family. How to reduce the risk of your loved ones so they do not have to suffer because of a major error you may commit as CEO? What to do with the money you earn so you can enjoy it as a pensioner later? Chapter 12 teaches you that.

But once your hair is white and your back is bent, you shall think about the future after your life ends. Wise owners think well ahead not only about their estates but also about who will follow them as top managers. Chapter 13 reviews what you should not forget that time.

### UNIT 11: Wealth management and financial planning

Personal finance is about the financial decision making of an individual. These involve a wide variety of issues from using banking services (transferring money, taking loans, using credit cards), financing your home, optimizing your insurance portfolio, preparing for unexpected spending, saving for health care and university studies of your children, creating a safe pension and estate plan.

To be able to affectively address all these issues you do not only have to aware of the different financial theories, formulas, products and services, but you will need also to understand the needs, the behaviour, and the decision making of the given individual. In the real life these complex tasks may require the assistance of a professional financial planner who has to consider a number of ethical rules.

#### 11.1. Types of investors

Successful business owners usually accumulate higher private wealth than people working as employee do. Thus, it is more important for them to have a well-designed, tailor-made private wealth management plan. The first step top that is to create an investor profile. We have to review both the (1) situational and the (2) psychological characteristics of the given individual. (CFA, 2016, Reading 8-12)

During situational profiling first we have to identify the source, the current form and amount of wealth. This will help us to see whether the wealth could be expected to grow

from outside source (fresh accumulation) or rather, it will decrease due to ongoing need money need of the owner's life.

Next we need to consider stage of life on the individual to predict how her (his) future financial situation is likely to change. (Life stages are presented in Table 1.) This is vital as investment decisions are taken for long-term, usually for at least 3 to 5 years.

Table 1 Financial life stages of an individual

Stage	Description
Foundation	Base of wealth (knowledge, skills) created. Young age, long planning horizon, high liquidity need, high spending (tuition fee, marriage, young children, setting up a new business).
Accumulation	Rising income, increasing expenses (home purchase, health care, education for children), wealth accumulation starts at later years when children grow older.
Maintenance	Preserving wealth becomes the main issue. Shortening investment horizon, low risk taking willingness, liquidity need rises as individual goes into pension.
Distribution	At the end of life investors start estate planning. High liquidity need due to potential accidents or illnesses.

Source: Based on CFA (2016, pp. 163-165)

As a next step, psychological profiling needs to be carried out. First, we have to review risk taking willingness (aversions) and risk taking ability. Traditional finance assumes usually that investors:

- exhibit risk aversion;
- hold rational expectations; and
- practice asset integration.

Risk aversion means that investors are assumed to ask for more return in exchange of taking higher level of investment risk. Rational expectations assume decision makers forecast future events in a coherent, accurate and unbiased way. Asset integration refers to the process of choosing among risky assets. Investors should always consider risk and return on a portfolio bases and assets should be evaluated based on their impact on the aggregate portfolio, not on individual characteristics.

Behavioral finance, though, has shown by experiments that individuals rather:

- exhibit loss aversion;
- hold biased expectations; and
- practice asset segregation.

Loss aversion means that investors wish to evade sure loss and thus they tend even to choose more risky alternatives if there is a chance to evade loss even if expected return is less than the sure payoff of the other option. In other words they might be risk seeking. Biased expectations lead to sub-optimal decisions. Examples include overestimating significance of low-probability events, having overconfidence in their own abilities or in that of a specific asset manager, and sticking to a particular asset or asset type. Asset segregation occurs when investors evaluate the performance of their assets on an individual basis and due to that they make decisions linked to a certain reference point, or depending on the way dilemmas are presented.

Figure 1 Investor personality types

	Decisions based primarily on	
	thinking	feeling
More risk averse	Methodical	Cautious
Less risk averse	Individualist	Spontaneous

Source: CFA (2016, p. 170)

Because of these effects, individuals may not take optimal investment decisions, and professionals should make special efforts to educate clients and make them aware of these possible mistakes. Even if doing this, they should respect the personality type of the individual. Figure 1 illustrates the four main categories. (CFA, 2016, pp. 169-170)

Cautious investors typically wish to hold low volatility investments with little potential loss of principal. Methodical investors at the same time focus on "hard facts". They use market analyses and research, but their decisions are usually conservative.

Spontaneous investors very often rebalance their portfolio as they react on any news from the market. They tend to follow external advice from very different sources while doubting them all. They decide very quickly and usually care little about risk. Individualist investors have a lot of confidence in market insight and data research, and are ready to accept more risk in exchange of higher return.

11.2. Setting targets and limits

It is in the Investment Policy Statement that investors and advisers should agree on risk and return objectives. Return requirement of the investor may be very far from possibilities and primary depend on her (his) personal situation and plans. Thus it is more adequate to set first any limitations regarding the portfolio and then to set the target (benchmark) return in line with those requests.

To set the risk objective we should first tell apart the investor's risk taking willingness and risk taking ability. While the willingness is more linked to the personality of the individual, the ability to take risk is dependent on the situational profile. There could be serious

ethical (and legal) challenges risen if these two factors differ considerably. If the investor wishes to take less risk than a professional advisor considers adequate, the consultant should educate the client. If the investor still insists on a sub-optimal level of risk, a written consent should be required to go on with planning and building that portfolio.

On the other hand, if the investors seeks to take more risk than optimal even once learning about the points of the advisor, there should be no portfolio management contract signed. It is unethical to put the investor into a too risky position even at her (his) explicit wish. (We also wish doctors to refuse to perform unnecessary risky operations on a patient who asks for that.)

Beside of that of the risk, it might be adequate to respect several other limitations when setting up an investment portfolio. Usually the following issues are to consider.

(1) Liquidity refers to the portfolios ability to address any predictable and not predictable cash need of the owner. These could be dealt with by holding a considerable amount of cash in deposit or choosing investments that are easy and cheap to convert into cash. In this latter case, we have to consider transaction costs and price volatility of the assets held.

The liquidity need may not only be heavily depend on the salary and other income of the investor but also on her (his) insurance portfolio and other reserves. An individual should first consider to gain adequate protection for health care, property damage, potential liabilities, accidents and the like before setting up an investment portfolio. Without that, the portfolio return will suffer because of the huge liquidity need of the investment.

(2) Time horizon describes the expected length of keeping our investments with the given weights of asset classes before liquidating or radically rebalancing. Determining the time horizon needs expertise and can not be completely left to the investor. A young freshly graduated individual may consider a very long investment horizon as adequate but founding a family and having children may very soon ask for a bigger home. Later, the children entering the higher education may again create a liquidity shock. At the same time a fresh pensioner may see their investment horizon be very short while in some countries it is common to live more than 20 years after that date.

(3) Taxes should also be taken care of right at setting up the portfolio. Different individuals may belong under different tax regimes or rates. Price gain, dividend and interest received could fall under tax schemes and thus modify the net return considerably. It is not only the nationality of the investor but also the country of origin of the payments that will influence how big tax burden we face.

Family businesses, especially less strictly regulated micro and small enterprises, may allow for optimising tax on benefits paid to family members. Company cars could be used by family members or salary of owners may be partly replaced by dividend payments. As most of these activities are usually prohibited to hinder tax evasion, owners depend highly on advices of their accountants or tax consultants. In addition, we should not forget that personal taxation always depends on the legislation of the country and different family

members may have diverse preferences in personal taxation. Thus, wealth management at family level may be very challenging.

(4) Legal and regulatory environment may put a limit to the assets available for a given investor. Some countries set a limit for high-risk assets in a pension plan, and sometimes due to tax considerations the personal wealth of the entrepreneur is not controlled by the individual directly, rather some kind of trust with special restrictions.

(5) Unique circumstances and limitations include all possible other constraints that could originate from the personal preference or situation of the investor. We may see individuals not willing to invest in a particular region of the world (e.g. countries under dictatorship) or in certain industries (arms, tobacco, alcohol). Some may have beside of the portfolio various other investments (real estates, collection of art or old cars), that should be considered when finding the optimal weightings of asset classes.

One of the unique circumstances that we should not forget about in case of family business owners is philanthropy. (Jennings et al., 2010) Supporting less successful family members, local organisations or a charity is common among well-off entrepreneurs. This might require some stable income or a certain liquidity from the portfolio.

Still, it is doubtless that in case of family business owners the most important unique limitation is that their total personal portfolio is usually extremely heavily weighted towards equity in a given industry as most of their wealth is still in form of shares of their own company. That is why an optimal personal portfolio of a business owner may contain far lower proportion of shares than for an otherwise similar individual working as an employee.

Family business owners (similarly to top executives of multinationals receiving bonuses in shares for several decades or poor individuals inheriting a relatively precious real estate) usually hold so called concentrated positions, meaning there is huge weight for one specific asset (equity of their own firm) in their personal wealth. (CFA, 2016, Reading 11) This creates special challenges for private wealth management, as usually owners are unwilling to sell any part of their business. Some of the key issues to take care of the following.

(1) Taxation. Due to not willing to sell some assets over a long period of time, once liquidating this holding there could be a huge difference between the bases price and the selling price leading to a high tax liability. This could be seen as a bad surprise as investors tend to forget about that when reviewing their portfolio.

(2) Liquidity. Concentrated positions are usually illiquid, thus any personal liquidity need should be covered from the rest of the wealth. Due to that, the remainder of the wealth will see a loos on return as a considerable part should stay over the long run in liquid low-return assets.

(3) Regulations. Company insiders usually face a huge number of rules and limitations when they wish to trade their holdings. They can not sell or buy when having access to material non-public information and even when nothing like that happens they might

need to publish details of their trade and answer various questions of different market players.

(4) Contractual restrictions. In public companies, owners may have to promise not to sell their holding for a while after an IPO (lockup), and there could be other “blackout periods” during which no owner, manager or employee may sell her (his) holdings. In case of private companies liquidity may be limited by a right of first refusal, meaning that equity holders may only sell to a third party their package after offering that under the same conditions to fellow-owners first.

(5) Liquidity of the market. Given that when in need investor has to sell a huge amount of the same share, low liquidity of the markets may strongly lengthen the time need and limit the available income.

We also may see a number of emotional and cognitive biases in case of holder of concentrated positions. Among others, they very often suffer of overconfidence due to the illusion of knowledge, while knowing a firm could be completely different to know the market and future price tendencies. Owners (particularly founders) tend to overestimate the value of their holdings as they wish to get compensated for non-monetary returns (fame, power, political influence) lost with the package. It is also common to experience the illusion of control, when owner believes (s)he can influence all material factors and thus a sudden loss in value is not likely.

In case of both targets and limits and investor characteristics, it is vital that investment policy statement is updated at least at a yearly base. In case of any material change in the life circumstances of the investor, an immediate update might be necessary. Due to this, wealth planning for a family business owner should not only be done once in life, rather this is an ongoing process, which needs continuous communication with a specialist and regular rebalancing of the portfolio.

### 11.3. Asset classes

When deciding about the right investment strategy, we have a wide range of choice of different asset classes. These classes do not only differ in their return pattern but also in their risk. Thus combining them into a diversified portfolio may add value and reduce risk while keeping return at the same level. Main asset classes are as follows.

(1) Fixed income assets are debentures like bills, notes, and bonds. Those may produce interest income and principal payments. The return available depends not only on the credit risk of the issuer but also on the payment timing. Sovereign debt issued by governments and denominated in their own currency contains the lowest repayment risk, while high-risk junk bonds of nearly bankrupt firms may contain extra high uncertainty. Inflation risk of these assets could be high if the interest rate is fixed and none if that is indexed or floating. While there could be bonds issues for 30 or 50 years on the market, the highest liquidity is usually available for short-term (some months) treasury bills. To keep liquidity it is wise to focus on listed fixed income assets but due to this over the counter assets may offer higher return at low liquidity (higher risk).



(2) Equity represents a small stake of ownership in a certain company. The risk of this investment may vary heavily depending on the level of development of the given markets, the trading activity on the given stock exchange, the size of the company itself and its popularity with the investors. In case of family business owners we should try to diversify into other industries, countries or geographical regions so those shares have very little covariance with our firms performance (do not tend to perform similarly). In the long run shares offer a higher return than fixed income assets at a higher risk level (more frequent and higher extent price fluctuation). As the higher return measured by long-term statistics is available only over a longer period on average, it is not recommended to have share in a portfolio held for very short time.

Beside of these two main groups very often all other options are simply called (3) alternatives. These include a huge variety of very different assets, which are usually less liquid and regulated, raise higher transaction fees, while the markets are less transparent. On the other hand the price of these assets usually shows little correlation with traditional investments and they also produce on average a higher return.

(3a) Real estates may offer you inflation protection, but may require several month to sell and even one unit may represent a huge value. If a family business owner owns a flat or a house, than typically the personal portfolio is already over-weighted towards real estates, so it is only in case of very wealthy individuals that a recommended portfolio would contain purchase of other real estates. Instead, we may opt for real estate investment funds. Real estates may have very different connection to economic tendencies: residential, commercial, industrial, and office buildings may show a change in value completely different to that of farm and timberlands. The key factor in each case is location, but the same plot may be optimal for one kind and terrible for another kind of real estate investment.

(3b) Infrastructures like highways, pipelines, ports, railroad or airports that are sometimes quoted as a separate class have many common characteristics with real estates. These assets are rarely available through investment funds, while direct investment may need an extremely huge personal wealth to keep us well diversified. Regulatory risk could be particularly high for these investments.

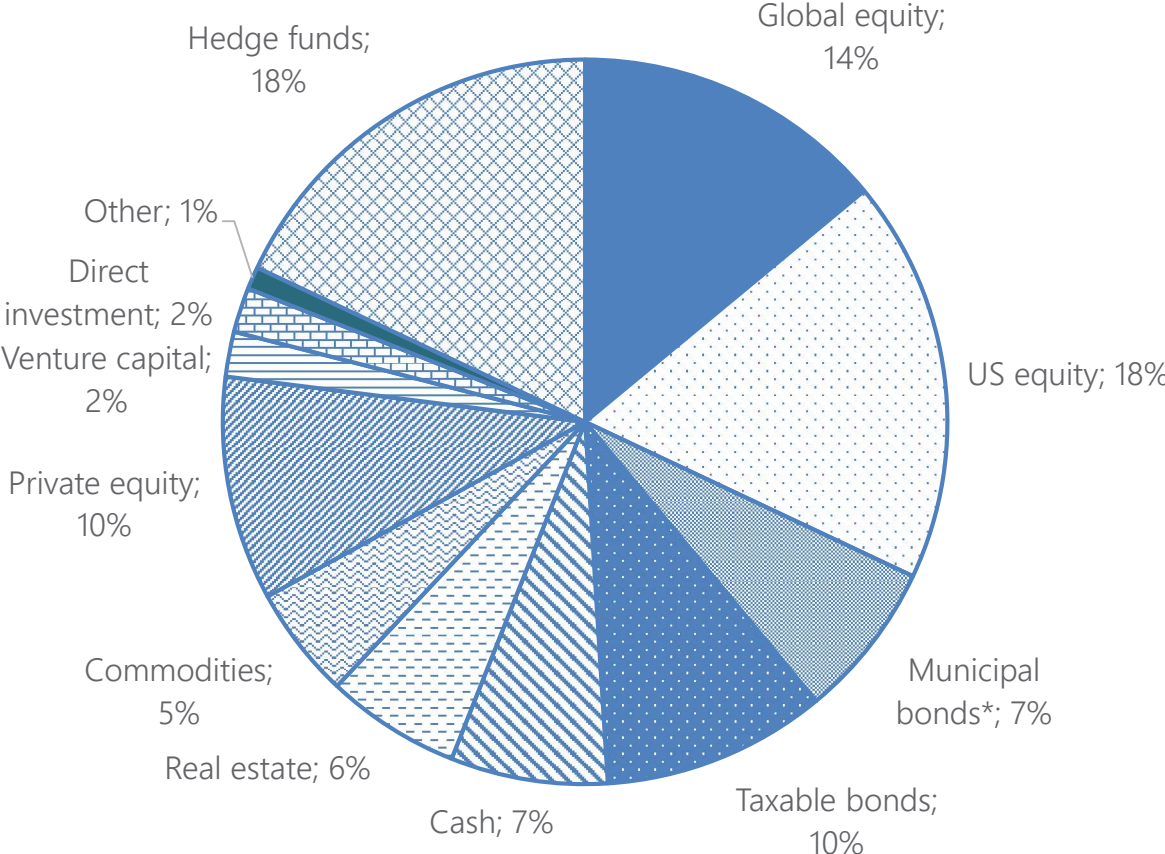
(3c) Commodities like grain, gold or even weather may be available on exchanges. Still in most cases position is taken trough derivatives (financial instruments that have their value linked to an underlying classic asset) so actual purchase and sells would not happen and no storage costs emerge. These assets may offer a hedge against inflation risk, and could have their unique connection to economy. Some commodities perform well once economy is booming as those are used as raw material by the industry (oil, coal, coffee). Others may serve as a protection against depression (gold, diamond) and thus could perform to their best during recessions.

(3d) Art and collectibles (stamps, cars) require special knowledge to manage, may have high transaction and storage costs, and are usually very illiquid. Some of them require

several decades as an investment horizon, and may be still very risky (contemporary paintings).

(3e) Hedge funds are investment companies specialised on complex and usually very risky investment strategies performed on organised markets. As the transparency of these funds is very low and they usually do not publish their investment strategies, it is extremely hard to estimate their risk and judge whether returns produced are in line with requirements.

Figure 2 Asset allocation of the Super-Rich



\*Municipal bond are tax exempt in the US.

Source: Based on Blodget (2013)

(3f) Private equity funds invest typically into non-listed firms to take profit of its future turnover, transformation or growth. The probably most well-known subgroup is Venture capital that focuses on private firms that might show a radical value increase if adequate funding is provided for a rapid development. Most of these funds are closed-end, meaning that it is not possible to redraw money before the end of the predetermined investment horizon of 10-15 years.

Figure 2 illustrates the average portfolio of the wealthiest US families in 2012. Those with at least 200 million USD of investable wealth may already have an extraordinary high proportion of risky assets like private equity, venture capital and hedge funds. Note that

even these families do not see it adequate to have to more than 2 percent of their portfolio in direct investments (that is holding the equity of firms). The diversification problem is well illustrate by the fact that a typical family business owner may have 60 to 90 percent of her (his) wealth in the company, and most of the rest is represented by her (his) home.

#### 11.4. Dealing with risks

Owners of family businesses tend to have different attitude towards risks than regular managers. This is caused by the overlap of family's own personal wealth and the company's wealth. Thus, a loss event can cause not only a loss for the firm, but for family members as well. For example, if the business car is used by the owner for family purposes as well, loss of the car can cause not only losses for the business (i.e. not realised profits), but for the family as well (the children harder to transfer to kindergarten).

Uncertainty is the lack of precise information about what will happen. If we know the (1) possible outcomes (what might happen), the (2) probability of those happening, and the (3) payoffs linked to the possible outcomes (our gain or loss if something happens), then this uncertainty can be managed by the means of probability calculus. In this case, the uncertainty is called risk.

We have to tell apart the symmetric and the asymmetric definition of risk. Under the symmetric definition, we consider any deviation from the expected outcome as risk, while the asymmetric view would only focus on probability of outcomes worse than our current state. Thus the two definitions do not only differ in the direction of deviations considered but also in their reference point.

To measure risk, we should have some information regarding the future. Based on where this information is taken from, we distinguish between objective and subjective risk. Objective risk is result of a calculation based on former experiences (projection). Subjective risk at the same time depends on the person and her (his) actual mental condition and reflects her (his) feelings concerning the future. For example, a person who is afraid of car accidents behaves more cautiously in the traffic, because of higher perceived level of risk. Overconfident drivers at the same time underestimate the probability of an accident and thus underestimate the risk itself. Other circumstances may also influence perceived risk. For example a person, who normally drives according the actual traffic situation and signs, after drinking some beer may drive more aggressive due to lower level of perceived risk.

The ability and willingness of taking risk is strongly influenced by not only external but internal factors as well. The culture of the person, the norms, social background, ethics, individualism, harmony, group cohesion, uncertainty avoidance are highly involved in corporate risk taking questions (Li et al., 2013). In the business practice, we differentiate the following types of risk:

- personal risk;
- property risk;
- liability risk;
- commercial risk.

Personal risk relates to personal issues, such as health or employment issues and even the risk of death. Usually a wide variety of health, unemployment, casualty and pension insurances are available on the market. In case of wealth planning we have to make sure that the investor has already taken care of these contracts.

Property risk is related to the materialised wealth, such as to real estate or cars. Main perils are damages (storm damages on the house), crime (stolen car), and accidents. Similar to personal risk, a wide range of property insurance is available on developed markets.

Figure 3 Risks to address in private wealth management



Source: Based on Jennings et al. (2010, p. 5)

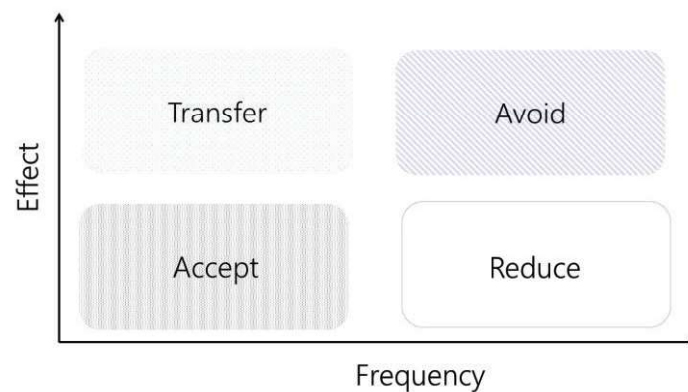
Liability risk refers to events where someone else suffers a loss because of us. People can cause injuries, damages or financial loss. The most important attribute of this risk type is that theoretically there is not upper limit of the possible losses. For example, if an auditor made a mistake in her (his) practice, (s)he can cause huge losses to stakeholders of the given company.

Commercial risk is the performance risk of a business. Very often a serious risk event hitting the owner would have an effect also on the business itself.

As for the private wealth management process itself, we need to address various risks. (Figure 3) Of all those personal risk (health and longevity and mortality risk) only gives a small part, as that adds to all the classic effects influencing the success of our investment plan (Jennings et al., 2010). While most of these risks are to be managed by the

professional wealth management firm, personal risks are usually out of their control. Thus, it is the individual and her (his) immediate family who have to take care of her (him). To minimise any negative effects we may choose from four different general strategies. (Figure 4) For low effect low probability events (flat tire), acceptance may be the most adequate. Acceptance can be both passive and active. In case of passive acceptance, we do nothing particular besides simply allocating reserves (time, money) for the case the event would happen. Active acceptance happens if we do something (carry spare tire) probability of happening or potential loss caused by the risk event.

Figure 4 Basic risk management techniques



In case the event is rare but it has a huge effect (fire) transferring the potential consequences to a third party may be the best idea. A classic example is insurance where the insurance company can create a well-diversified portfolio of the risk so it is better to let them deal with the risk. Huge effect, frequent events should be evaded and prevented (hinder fatal accidents by prohibition of entry), while low effect, but high frequency outcomes should see their chance of occurrence be reduced (warning about wet floor). Of course, in many cases we may combine these techniques.

In personal wealth management acceptance justifies holding safety cash or other liquid reserves just for in case, while transferring calls for a well-established insurance portfolio. Avoidance means being careful at all times (no road racing or rock climbing without rope) and reducing could be interpreted as setting up an alarm system (smoke and fire detectors, anti-burglary system, direct call to 911 or 112) in your home. It is only after all this is done that investors could correctly estimate they wealth to invest and estimate future additional payments they will be able to contribute to the portfolio.

Risk management is not always welcome by everybody and may also raise ethical issues. Chansog et al. (2014) calls the attention to the specialities in risk management for family businesses. As owners have a huge part of their wealth in form of concentrated investment in the firm it could be in their interest to perform risk management actions that are normally done by the investors at portfolio level within the family business. For example getting rid of industry, country or currency risk could be done by holding a

diversified portfolio, the limited personal wealth of the family business owners does not allow for that. Thus, risk management costs may be forced on the company, what may hit profitability and create a sub-optimal situation for non-family member shareholders. Authors examined the S&P500 companies to learn that without considering the effect of risk management policies (operational diversification, use of derivatives) family firms create more value for the shareholders. While risk management usually adds value on the top of that, in case of the presence of founding families that positive effect disappears. (Chansog et al., 2014)

### 11.5. Conclusion

Wealth management is vital for family business owners. They need to think about the future of the family for even those cases when the business could underperform. To develop the optimal personal financial plan, we need to understand both the situational and psychological characteristics of the owner. Then we need to identify any constraint to set risk and return targets and find the optimal asset allocation.

Family business owners have concentrated positions due to their holding, what generates additional challenges to overcome. Balancing and diversification becomes more complicated, and the huge proportion of the family business equity in their portfolio may also distort the functioning of the enterprise risk management system.

We have also seen that before of wealth planning, owners have to think about the risks of their everyday life and seek coverage for those. It is only after setting up an adequate insurance protection and estimating safety liquidity need that we can identify how much of the wealth could be invested and what future addition payments investors will be able to add to that.



Mrs Maria Horváth (40) has a degree in management and is the top manager of a family business running a restaurant in the centre of a rural city in Hungary. She holds 60 percent of the firm while his husband (45) who works with a multinational company as a lawyer owns the rest of the shares. They have two children. Their son will enter university next year while their daughter started secondary school a year ago. The estimated value of the business is 120 million HUF, but they also own the house they live in valued at 40 million HUF. Currently they can save 150 thousand HUF each month, and the salary of Mr Horváth alone would be just enough to cover current monthly basic costs of living. The family has two middle class cars and tend to spend two weeks of holyday together each year. They have the obligatory liability insurance for their cars and have some basic insurance coverage for their house too.

The total of their current savings amounts to 12 million HUF the most of which is in their current account managed by the local branch of the biggest Hungarian bank. They are lucky no to have any debt. The parents of Mrs Horváth lives in a nearby village and went to pension recently. The state pension system is not very generous, but enough to cover all their costs of living currently. Only the mother (73) of Mr Hováth is still alive. She suffers from several illnesses and has more and more difficulties to manage her life alone. She lives 100 kilometres away from the family. Mr Horváth has no bothers or sisters, while Mrs Horváth has a younger sister (32) who recently moved with her boyfriend to London and is currently looking for a job. They plan to marry and have children once they set up their life in the UK and will be able to save enough money for the costs.

1. Describe the current financial situation of the couple and propose wealth management steps you consider necessary.
2. Identify limitations and set investment targets for Mrs. Horváth.

### 11.6. Reflective Questions

1. What factors do you have to consider when creating your personal financial plan?
2. What types of investors can we tall apart?
3. What are the special challenges of private wealth management for a family business holder?
4. What kind of risk should you deal with in personal wealth management? What are some of the methods to do that?



## UNIT 12: Succession and estate planning

Who will do my job once I have to leave? As years go by, this question becomes more and more important for the owner-top manager of family business. (S)He has not only to choose the right heir optimally years before the actual replacement takes place, but if giving the control over to a family member, the compensation of other family members should be also planned well before. This chapter reviews key issues of succession and estate planning to offer an insight into the complexity of the problem.

### 12.1. Introduction to succession planning

Succession planning is the process of planning the transfer of a business because of the individual serving as both main owner and top manager willing to leave the business. While generally the succession can involve a transfer to employees or external buyers, in case of family business the most typical aim is to transfer to members of the owner's family once the owner retires. The aim of the process is to assure a smooth continuation of the business, at least in the short term. Business succession planning (BSP) is a complex process covering not only legal, financial, taxation, psychological, organisational, and educational issues of the transfer but also considering various exit strategies. (See chapter 11.)

Succession planning is similar to replacement planning but this latter aims at short term replacements of any key personnel, while succession planning is usually about the final (or long term) replacement of the main owner or a member of the top management, and involves extensive and lengthy selection, education, and training.

Not caring about succession planning may end in a serious shock for the company when the current key person leaves. A sudden loss of the owner and top manager may force the firm to finish its activities no matter how profitable those were. In Europe, only 5 to 15 percent of family businesses reach the third generation, and 30 percent of the family business closures are due to succession planning failures. (Barry – Gabriel, 2006) Even when considering 2400 of the world's largest family businesses (Ernst & Young, 2017), we find that only 8 percent of those made it until the fourth generation. (Table 1)

Research shows that owners usually have a very strong desire to have their own children, very often the first-born son to follow them. This gender issue raises serious problems as empirical evidence found no difference between the performance of women and men as a successor. Still, women belonging to the family complain of less constructive feedback on their work and weaker self-confidence due to this missing information.

The selected heirs may receive a preferential treatment not only within the company but also within the family regardless their abilities. This phenomenon is usually considered to have a negative effect on the individual and her/his acceptance within the organisation and the family. However, for a successful succession, also most of the key family members should support the choice to hinder rivalry and intense disputes. Nevertheless, even if the

heir is well received by inner stakeholders, the market may consider the mere selection of a less experienced heir as a negative news leading to a fall in share prices. (Barry – Gabriel, 2006)

While there are many difficulties of succession because of the firm being controlled by a family, there are some advantages too. In a family business, owners have a natural desire to care about succession; other firms, particularly the smaller ones may see a far higher risk of succession issues being completely neglected.

Table 1 What generation are you? – World biggest 2400 family business

Generation	Proportion
First	40%
Second	32%
Third	20%
Fourth	4%
Fifth	2%
Above that	2%

Source: Based on Ernst & Young (2017, p. 14)

Grassi and Giarmarco (2008) list five key steps to create a successful succession plan. First (1) we have to determine the owner's long term objectives for the family business. Then (2) the financial need of the owner and her (his) spouse should be mapped and a plan to cover those has to be set up. Next, (3) owner has to select the successor taking over the top manager role. The selected person (a family member or a trustworthy employee) has to be introduced into the daily management issues. After that (4) the current owner has to decide who will get the ownership of the firm. Heirs should be treated fairly, but not equally (see chapter 13.2 for further details). As a last step (5) we should look for the legal structure that minimises tax payment duties. As this is a lengthy and complex process which also calls for help from outside (business, financial, legal, valuation, tax) specialist, it is recommended to start the process about 10 years earlier than the owner wishes to retire. Staehr (2015) underlines that this process is also great to attract new professional knowledge into the business from the consultants to boost productivity and profitability.

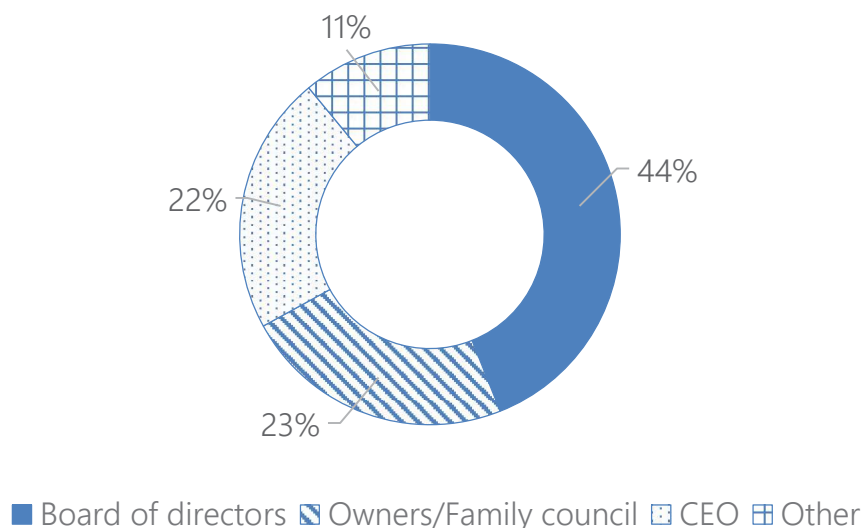
To insure the success of a succession plan, owners usually need to have a well performing estate plan. To keep fairness within the family children not selected to be the main owner of the family business should feel equally treated regarding the whole estate. This request may raise several problems, as under normal conditions succession should precede by several years the inheritance. This is why performing an independent and high-quality business valuation (see Chapter 10) could be vital in almost any case.

Based on the literature (Hubler, 1999; Getz – Petersen, 2004) and our own experience the most important negative factors to influence the success of succession are the following:

- current owner unwilling to think about leaving;
- lack of adequate heirs (absence or bad personal connections);
- life-stage incompatibilities (e.g. children too young);
- potential heirs not willing or able to take over the business (different interest, not adequate education, low profitability and personal income available, remote location of the business);
- gender (e.g. prejudicial treatment of daughters);
- rivalry and heavy disputes within the family;
- shortage of time available (e.g. unexpected serious illness or accidents);
- the business is not viable to transfer due to special personal characteristics needed (e.g. artist, doctors);
- inheritance/income taxes make succession impossible to finance;
- legal issues block the transfer.

It is hard also for an heir to take over the company. Three of four of the world's 2400 biggest family businesses require family members to work outside the company for 2 to 5 years before joining the family business (Ernst & Young, 2017). Every tenth of those companies even require a longer outside experience, than that.

Figure 1 Who has the primary responsibility for succession planning? – World biggest 2400 family business



Source: Ernst & Young (2017, p. 15)

Family members have to perform well in various aspects as in case of these big firms, as usually a committee takes the decision on who could become a successor. (Figure 1) Based on empirical findings, heirs need at least 12 to 18 month to completely take over their new task and reach their full productivity.

## 12.2. Estate planning considerations

It can be very challenging for an individual to think about how the world will go on once (s)he dies. Still it is worth planning well in advance not only to insure that this event will cause the smallest shock possible for the loved ones and the business, but also to hinder scary surprises to follow later. Estate planning is deciding about the ownership of your belongings after your death, in contrast to succession planning where you decide about who should take over your positions and job.

When transferring the ownership of a business to someone legally we may either classify that as a gift or a sale. (Reardon, 2008) With adequate planning, these are alternatives to inheritance. The main difference lies in the income tax considerations of both parties. To see the importance of this issue, it is enough to consider that in the US for example, estate tax alone can claim 45 percent of the business value. (Grassi – Giarmarco, 2008)

In case of a sale the seller realises a capital gain defined as the difference between the basis price at which (s)he got the ownership and the selling price. Very often the basis price is extremely low as the founder created the firm with a relatively low investment probably several decades earlier.

On the other hand, buyer has to come up with adequate liquid cash to pay for the firm. (S)he may need to sell off some of her/his investments where the realised price gain is taxable again. If using savings in deposit for the payment, personal tax was paid on the given income earlier.

Once most of the business is only passed over after the death of the owner, life insurance can play an important role in estate planning. (Grassi – Giarmarco, 2008) If the heir is the beneficiary of the policy, the final payment may offer a good source to cover tax liabilities from.

Giving away the shares as a gift might look to be a better solution. In that case the former owner has not to pay tax, but the receiver of the gift may have to do so. The tax base might be calculated very differently from country to country. Though, this method raises at least two further questions. (1) What will provide adequate retirement income for the former owner of the firm? (2) How and when will the other family members (e.g. other children) be compensated to assure they are treated fairly?

A potential solution for the first problem would be the firm paying a compensation to the former owner. Here we have to assume that the company will be profitable enough to pay the adequate amount over a potentially long period of time. Also there should be a legal guarantee that later owner will not cancel or reduce this payment. When setting the amount, you should not forget that these payments from the firm usually do not enjoy any tax benefit that that normal pension payments might get. It is also advisable to index these payments to a cost-of-living factor. (Reardon, 2008)

Another solution to receive a compensation could be to lease buildings or other assets owned by the former owner to the company. An income like that might receive a

preferential tax treatment in some countries, but the lease fee should be set strictly following the transfer pricing rules of the given country to be tax deductible with the company.

These compensation agreements may cause a liquidity burden of the firm and limit payments to owners, so they also reduce the market value of the shares. Thus any personal tax payable by the individual receiving the gift may be lower.

When giving away a gift to one of the heirs we also have to assure the others clearly see how they will be compensated. Preferring one of the children over the others may radically deteriorate personal relationships and should be evaded to assure calm and enjoyable years in pension. Wiktor (2014) underlines that for the success of a transition holding a family meeting review all monetary, tax, and legal details well in advance in of key importance.

At the same time being fair does not mean everyone has to inherit equally. (van der Merwe, 2009) Because of different personal needs everyone will have a different view of what is fair. For example passive owners usually have other priorities than the heir chosen to be owner-manager as they do not receive any cash flow (e.g. wage) from the firm but dividend. But the extent of that is typically heavily influenced by the owner-manager thanks to her (his) share package.

Equality may harm also in another way. If two brothers receive 50-50 percent of the family business they will have to agree on each and every decision in the future so those could gain majority. Thus, equality can not only be demoralising but also dangerous for the business.

One of the common problems at estate planning is that many family business accumulate assets far beyond the needs of the operation. (Stanaland, 2008) This could not only be explained by the lack of planning, but very often by tax optimisation. It is typical to keep wealth inside the firm so the maintenance cost of assets like vehicles or pieces of real estate be corporate tax deductible.

Still, it is highly advisable to regularly redraw any excess of wealth to keep estate tax and chances of family dispute at their lowest. Also, this separation of personal wealth helps to protect family wealth from business mistakes assuming the firm operates under limited liability. If assets not needed for operation are removed regularly from the business it is also much easier to compensate family members not chosen for succession for not receiving as many shares as the future owner-manager.

In case of inheritance, unneeded assets within the firm can not be sold to come up for estate tax payments what may limit the liquidity of the family considerably. On the top of that, if it will be the firm itself selling off unneeded assets later on, the firm might realise a considerable gain compared to the basis price, and pay corporate tax on that, before heirs may receive a payment, that will be taxed by personal tax immediately once again.

Another useful practice could be to split-off individual business units into independent legal entities. (Stanaland, 2008) can be done both based on geographical areas or business activities. With adequate planning, individual units may be set up already while the owner develops a well-performing business. This technique could be also useful in case of a single heir as the family has the flexibility to sell only one of the business when in need of money. Thus, the total entrepreneurial wealth is easier to distribute among heirs. Each of them can be introduced to her/his own future business on time with an adequate succession plan.

For bigger companies, it could be a great idea to issue both non-voting preferred dividend shares and common shares (Drake, 2008). The former stocks may be passed on to family members not receiving the control over the company, while the latter is kept by the successor.

To increase flexibility in succession planning, we may also use the so-called passive assets. This name refers to assets that could be used by the company in the long run without radically decreasing the value of it. Examples include real estates, brands, and special vehicles. The owner or an independent entity may own these assets directly and lease them to the company to create a stable personal cash flow. Later the assets or the special purpose entity can be passed on to any family member not working in the family business.

No matter which technique is chosen, we always have to start planning early. To keep family connections at their best, it is a good idea to share possible ways and raise dilemmas at a gathering of all persons concerned. If estate planning is started well on time, both the sale and the gift could be broken up into smaller packages reducing the one-time cost tax payment. This is a key difference versus inheritance where the emotional shock goes very often hand in hand with a financial one: heirs may not be able to take control over the firm as they lack the monetary means to cover the inheritance tax. This may lead to the liquidation or forced sale of the business and results in serious loss in wealth.

### 12.3. What drives succession and estate decisions?

Motwani et al. (2006) investigated at 238 family-owned SMEs in the US about the importance of succession planning. They state succession planning is more important in bigger firms, and in companies with more full-time family employees. Bigger firms rely more often on external recruiting than smaller ones when it comes to find a candidate for succession. Most of the family members join the firm for altruistic reasons, and firms see the decision-making ability, the commitment to the business, and the interpersonal skills as the three most important successor attributes. In case of firms with less than one million US dollar revenue, you generally need also strong sales and marketing skills to be selected for a successor.

Based on five interviews with CEOs of Scottish family businesses of at least 400 years Belmonte, Seaman, and Bent (2017) found that family businesses are very conservative

when it comes to succession, and the selected successor is seen rather as a steward of the family wealth than the main owner of it. This means that to survive in the long run heirs do not only have to qualify as a businessperson but also as a trusted and caring family member.

Empirical findings show that real life decision making on estate issues at family businesses is well in line with the theory. When reviewing the quality of estate planning, van der Merwe (2009) examined 185 family owned SMEs in South Africa. He concluded that estate planning has a strong focus on minimising tax, while retirement planning, fairness, and liquidity of the company after the transaction are also among the key factors being considered.

Brunetti (2006) used US data to measure to what extent heirs are forced to sell the business to pay estate taxes. His results show that higher estate taxes significantly raise the probability of the business to be sold after inheritance, but he found no evidence on the level of liquidity of the families explaining these sales. This might be the result of contrary effects. On one hand, we may assume that people with more wealth pay more attention to estate planning, thus the forced sale of businesses is more common in less wealthy families. On the other hand, less wealthy families own firms with lower value on which estate taxes are usually lower in proportion.

### 12.3.1. Succession in a Hungarian family business

Mr. György Kovács has recently turned 70. It was some 40 years ago that he set up his engineering and special machine construction business together with his elder brother who has helped him to cover the initial capital need. Since then he served as a CEO of the family firm, which has shown considerable developments during the recent decades. Now, after an in-depth consultation with a heart specialist Mr. Kovács is under heavy pressure from his wife and family to step back from work, spend more time with the grandchildren and care more for his own health.

Mr. Kovács has three sons, who all were introduced to the business, but the first one of them lost quickly his interest for the firm, while the second had serious personal conflicts with the father because of strategic issues and quitted. The third of them has graduated as an engineer and has been working for the firm for 10 years by now. He currently serves as director for production. At the same time, the daughter of Mr. Kovács's latter brother works as a CFO for the company. She has been with the company for 20 years, and also holds 20 percent of the shares. The rest is owned by Mr. Kovács, who asked for a professional valuation of the business to learn that the total equity value is almost 200 million HUF.

Assets within the firm not directly needed for the operation amounted to 30 million HUF. The most valuable asset is the production hall of the company with a market value of approximately 50 million HUF, but the book value of that is well below 20 million HUF. In



addition to his home, Mr. Kovács personally owns one real estate worth of approximately 40 million HUF.

1. Propose a potential succession and estate plan for Mr. Kovács.
2. Describe the advantages and disadvantages of any possible alternatives.

#### 12.4. Life after succession

After understanding the process and empirics of succession, let us focus on what usually happens after the owner-manager is replaced by her chosen heir. Research show that passing over the firm from the first to the second generation could be significantly different from any other successions later on.

As we have seen in the previous part of this chapter, succession may create considerable financing need because of different taxes and the monetary compensation of not inheriting family members. The heavy money withdrawal from the firm may force the new top manager to take additional debt to assure smooth ongoing operation.

At the same time, once the owner and top manager change at the same time, risk of operation may increase, conflicts within the management and among new shareholders could rise, and trust of financiers with personal link to the old owner may evaporate. Besides, new owners and managers tend to take less (financing) risk than more experienced ones. The same is true once instead of a single person a group of young family members has to take a decision on the leverage. These effects could lead to a decrease in debt ratio.

Molly, Laveren, and Deloof (2010) examine 152 Flemish (northern part of Belgium) family owned SME successions between 1991 and 2006. They concluded that transfers from the first to the second generation tend to decrease the debt rate of the company while transfers between later generations have adverse effects. This might be because first generation companies tend to get financing by personal connections more often than firms do at a later stage. In addition, once a business has a record of successful successions, the perceived risk of a repeated event might be far lower.

As for growth and profitability, we find contradicting argumentations too. When the new generation enters the business strategy may change, and this process may lead to a stagnation and less focus on operational management. The family orientation of the business may also alter. More business focused firms aim at higher risk, profit, and growth, while companies that target to create stable family income usually reduce risk event at the cost of growth and profitability.

At the same time, younger people tend to take more risk, while elderly usually are more conservative. The newer generation tends to be more innovative and has more up-to-date professional knowledge, and may add considerable expertise gained outside of the family business. These may all lead to an increase in profitability and growth rate.



Based on the results of Molly, Laveren, and Deloof (2010), the growth rate tends to decrease after the second generation takes over, while lateral transfers do not affect it. As for change in profitability, no significant effect showed up.

Colot and Bauweraerts (2014) compared the succession effect for 102 family and non-family SMEs operating in Belgium. They conclude that in case of any succession there is a short-term fall-back in profitability, but the extent of that is smaller in case of family businesses. In family owned entities, succession also adds more value (higher increase in profitability two years later) than in their non-family owned counterparts.

### 12.5. Conclusion

Well prepared succession and estate plans are key for the secure survival of any family business. Owners should think about potential candidates well in advance to have enough time to prepare them for the task. Timely planning is also required in estate planning to assure that no family conflicts would harm the business and tax payments are minimised. Empirical research shows that bigger companies put more focus on succession planning and would more often choose professional outside of the family to carry on as top manager to keep the family wealth safe and secure.

While succession is always a challenge for the organisation itself too, it seems that in the long run added value coming from the new heir compensates any difficulties and stagnation right after the change. Still, even the biggest of the family business have difficulties to stay in family hands for more than five generations.

### 12.6. Reflective Questions

1. Describe the importance and key factors of succession planning.
2. What are the possible pitfalls of estate and succession planning?
3. Contrast different methods to pass over the family business to the next generation.
4. What makes a good successor for a family business? Whose responsibility is to find good candidates?

## SECTION III: Ethics of Business

Now it is time, to get out of the skin of the family business owners. Let us consider what the expectations of the society toward these entrepreneurs are and how they could evade all those ethical failures that are often automatically associated with these companies. Talking and thinking about ethics well before any challenge could arise helps considerably overcoming the potential temptation or finding the morally right behaviour in critical situations. Join us for a short walk in the twilight zone of ethics right at the edge of justice and law.

### UNIT 13: Ethical challenges

Ethics describes what people believe life should be like. Today, after a number of scandals, it is not enough anymore to respects the laws and regulations, you should be (and look like being) fair and honest. Moral questions arise each day in your business life and your choices may have long-term consequences.

To be on the safe side, the organisational culture should include moral requirements and supervisors have to make serious efforts so that all employees act in an ethical manner even if not being controlled continuously. Family businesses may have an advantage there, as owners usually do not want to risk their personal social recognition and the future of the firm. At the same time, the personal influence of the main owner is usually stronger than elsewhere, so the potential lack of ethical values of a small group of (key) individuals may affect the behaviour of whole organisation.

#### 13.1. Basics of financial ethics

Ethics describes the way the world ought to be. Financial ethics focuses on how financial tasks and processes ought to be managed. Thus, Financial ethics covers all the three main parts of finance: (1) public finance, (2) corporate finance, and (3) personal finance. In case of family businesses, the latter two fields play the most important role.

It is key to tell apart law and ethics. Law describes what you are allowed and what you are prohibited to do. Ethics focuses on what you should or should not do, so something could be lawful but unethical and the other way around.

There is no law that would force the shop assistant to be kind to the customers. Still, most of us agree that (s)he being impolite harms the business, and the assistant should work in the interest of the shop. At the same time, if the supervisor fires the assistant just because of not greeting a customer nicely once, we may see that as not fair. So, it is not ethical, but not punishable by law to be rude to customers once you are paid by the shop, which may lose money due to this. At the same time, it may be unlawful to fire an assistant because of being constantly unfriendly, though, morally we can perfectly understand the point of the manager.

Stealing is always against the law, but morally we may accept Jean Valjean stealing bread to feed the children of his sister. This conflict is key in understanding the behaviour of inspector Javert in Victor Hugo's *Miserables*: you may be a good person while committing a crime and a terrible one even if respecting all laws and regulations.

Why should you be ethical? Usually two arguments are quoted. On one hand, being ethical pays off. This is not only because there are a number of unethical and unlawful actions to evade but also because doing the right thing will create some happiness within you – even if none knows about your actions or choices. On the other hand, living with integrity creates a state of wholeness and helps you to take hard decisions more easily: some tempting options are out of question, and ethics gives you an additional guideline throughout your whole life.

In business, being ethical is key as stakeholders do not only condemn unlawful but also unethical behaviour. It is not only the firms and managers that were found guilty in a lawsuit that suffer a loss of their goodwill, but also those who are known and thought not to be ethical. Who wants to go to a garage, which is infamous for cheating customers with the repair bill, but was never condemned legally?

Why would still some of us behave unethically? Theory of the Fraud Triangle elaborated by the criminologist Donald Ray Cressey (1950) says we need three factors to be present at the same time to step off the golden road. These are (1) the pressure on the individual, (2) the opportunity to commit the fraud, and (3) ability to rationalise the crime. More than fifty years later, Wolfe and Hermanson (2004) added the new factor of (4) Capabilities, then finally Olukayode (2016) proposed the Fraud Pentagon (Fig. 1.) approach. After his opinion (5) personal ethics should be also considered.

Figure 1 The Fraud Pentagon



Source: Olukayode (2016, p. 164)

The identification of these factors is important not only to understand the behaviour of someone after an act, but also to hinder actions that superiors (teachers, parents) wish their subordinates (students, children) to evade. Need or incentive describes the cause or motive to perform an act, while opportunity refers to a chance that the person may exploit. Rationalisation is the understanding of the individual that the given act is worth doing considering the risk of it. Capability means that the give person believes (s)he has the necessary traits and abilities to perform the act, while personal ethics is the value set the individual accepts and follows in her/his everyday life.

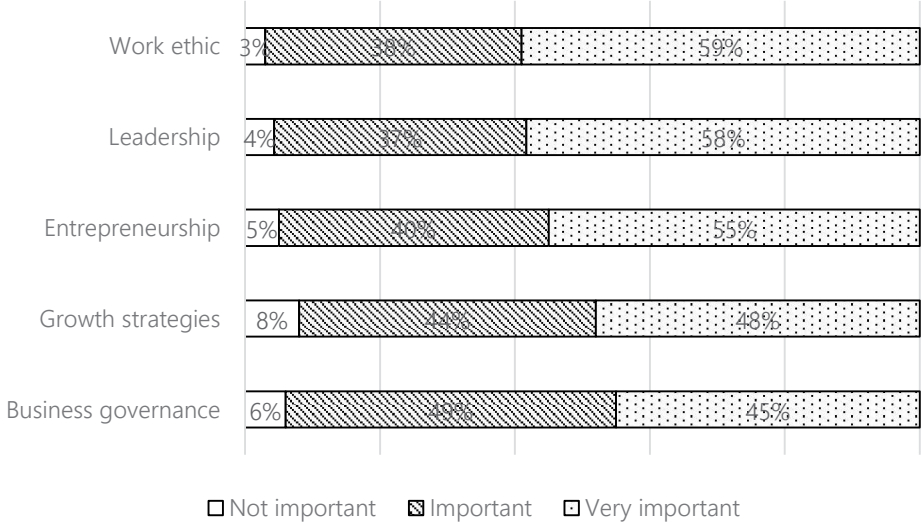
Based on this model, to hinder unethical (or unlawful) acts happening we should not offer an opportunity (strong and continuous control), make wrongdoing as hard and complex as possible (extreme capabilities need), and increase the chance and consequences of being caught to the maximum (strict rules, continuous monitoring) to make rationalisation harder. Also, reducing the need (fair payment, caring for employees individual problems), and building a solid ethical background would help.

Business ethics and particularly financial ethics gained importance during the recent decades. This is due to not only the expansion or Corporate Social Responsibility concept but also explained by the financial scandals of the recent years. First the WorldCom and Enron scandals broke out, which pushed the US government to pass the Sarbanes-Oxley Act. That law holds executives and boards of directors directly responsible for their companies' financial statements. The subprime meltdown in 2007 threw light on problems within the financial industry calling for more strict regulatory oversight.

Family businesses clearly see the importance of ethics in the changing world. In a recent survey, Ernst & Young (2017) asked 2400 of the world's largest family businesses to learn that 78 percent of those considers very important to foster ethical behaviour. The growing

importance of ethics is well reflected by the fact that these firms consider work ethics even more important than leadership or entrepreneurship when educating the younger generation joining the family businesses. (Figure 2)

Figure 1 How important are the following in educating and preparing the younger generation to join your family business?



Source: Based on Ernst & Young (2017, p. 16)

Still, it is very hard to judge whether and to what extent ethics is important for one given company. For example, corporate philanthropy is often considered as a marketing act, rather than a sign of considering moral values. Du (2015) examined Chinese family businesses and found strong connection between corporate environmental misconduct and philanthropic giving. He assumed that the latter served mostly only to divert attention from the misconduct. This diversion theory is also supported by the fact that companies with loser tight to politics were more likely to use philanthropy when performing environmentally unfriendly actions.

13.2. Are family businesses more ethical than other companies are?

Are family business more ethical? The picture is still far from being clear, as several factors play a role in this. Family businesses tend to be smaller than average companies (easier to monitor) and so less strictly controlled by authorities (less chance to be caught), while usually for the decision makers there is more to lose as the social control (e.g. by family members, friends) is more intense (not only legal but also strict social punishment). Also, even when finding significant differences we may not be sure what factor lies behind. It could be the size effect, or that of the intense personal control that enhances integrity or the bigger risk of mixing up individual and business targets and interests and the weaker attention from the regulators that makes wrongdoing easier to rationalise. This is

because we may not find a unique pattern of ethical behaviour across the family businesses.

When investigating this issue in the US, family business expressed a stronger link to ethical values than their non-family counterparts did. They mainly focus on integrity and honesty, while the rest of the firms prefer environmentalism, globalism, and social responsibility. (Blodgett, Dumas, and Zanzi, 2011) Based on the frequency of ethics values appearing in the business mission statements, the importance of ethics has clearly risen at family business after year 2000.

One of the biggest ethical challenges family business manager face is to achieve fairness between family and non-family employees at workplace. As family members may offer a unique and distinct contribution, it is very hard to judge whether fairness is maintained. Some companies do not even set that as a target, while research supports that promoting that value would boost performance and the well-being of employees. (Samara and Arenas, 2017) Offering equal opportunities to everyone within the company is crucial for the profitability, the long-term survival, and reputation of the business and could be key to preserving the socioemotional wealth of the company.

Working in the family business might raise another problem too. Parents usually wish to teach their children how the company runs. Thus, they tend to find jobs to do for the next generation even at early age – something that could jeopardize the health of the kids if safety instructions of the parents are neglected. A US research showed that 42 percent of the children aged 14-17 were working. Of those 34 percent were involved in a family business. Students working at family business were more likely (33 vs 21 percent) to report serious injuries affecting their life for longer than three days. They were more likely to get hazardous tasks, sometimes even ones prohibited by relevant regulations. (Zierold, Appana, and Anderson, 2012)

As for financial misconducts like embezzlement, fraud, and theft, it seems that small family owned business are less likely to experience such problems than other companies what could be explained by the closer control of processes. When also considering the age of the businesses an inverted-U curve describes the probability of financial frauds happening. Thus, lower probability than elsewhere only emerges for young companies and in case of mature firms with older owners. This later phenomenon could be the result of elderly willing to keep their firm and reputation safe for the next generation. (Shujun and Zhenyu, 2014)

The use of questionable accounting practices is also often cited as an SME characteristic due to less intensive control of the regulatory bodies. But is family ownership decreasing this risk? Steijvers and Niskanen (2014) review the application of tax aggressive accounting aiming at decreasing the tax base as much as possible employing sometimes even illegal techniques. Based on a Finish sample, they concluded that family owned companies are

less tax aggressive than other private firm. Once the CEO has lower stake in a family owned entity the tax aggressiveness grows, but the presence of an outside director decreases this effect. This finding again supports that family members care more for the fame of the company (increasing chance of a tax investigation). This enjoys the support of both the CEO personal ownership and an outside director who might lose his personal goodwill in case of a fraud.

Also linked to accounting, Ma, Ma, and Tian (2016) investigated on a sample of Chinese firms whether frequency and price effect of accounting misstatements and restatements would differ across family owned and non-family businesses. They found that family control decreases the likelihood of misstatements that might be explained by the controlling families having greater concern for reputation (harder rationalisation) than blockholders of other companies. Given that, it is no surprise that a restatement in case of a family business triggers more negative market reaction (bigger surprise). This is because there is a greater loss in reputation and investor scepticism of the credibility of corporate insiders will also be higher for family firms than for nonfamily firms following restatements. Before generalising these results, we should not forget that the rate used for corporate taxation is an important factor in pushing the tax aggressiveness of the firms. Due to this, we may expect to find different trends under different regimes.

In case of listed family owned firms, it is often assumed that family members may more easily take advantage of information leakage when trading for their own portfolio. It is important to see that such actions are not necessarily illegal. Information that is not available to the public but would have a material effect on the price setting if being shared is called insider information. It is only to trade on those what law usually prohibits.

At the same time, combining non-material non-public information with public information (also called mosaic theory) is in general legally not restricted, but could be considered unethical by the public once it leads to significant profit. That is why all trading activity of close family members of business insiders are to be made public immediately.

If a considerable amount of shares of a public firm is in the hands of a family it is natural that family members would pay more attention to the given stock and it is also them noting extraordinary behaviour (a classic non-material information) of the family members directly involved in the management. Recent research found no clear connection between family ownership and trading activity of individuals closely linked to insider information holders.

At the same time, it seems that the information content of the trades of non-family insiders is far higher than that of family members (Sun – Yin, 2017). This might be explained by relatives caring more for the reputation of family business than others, even if the business is public.

Anderson, Reeb, and Zhao (2012) focused on short sales on US shares to investigate the issue. During such trades the investor borrows a package of shares and sells it to repurchase and hand it back at a later point in time. This allows for speculating on

downwards price movements. Their result show that prior to negative earning shocks times higher for family owned companies than for non-family business. Also, the information content of daily short sale activity seems to be higher for family-owned firms than other companies. A potential explanation for that could be the more lax information protection. Based on the data, we can not decide whether those trades driven by the mosaic theory (investors paying more attention) or illegally based on insider (material, non-public) information.

### 13.3. Conclusion

Business ethics has gained considerable importance during the recent decades. Respecting all the laws and regulations is a minimum, but very often not enough to keep your reputation. At the same time, social responsibility that might be derived also from ethical values may also be used as a pure marketing too only. The growing importance of ethics is well reflected even in the family business, which usually put a special focus of work ethics when training the next generation to lead the company.

Recent empirical research shows that family owned firms are usually more value conscious, as owners do not want to risk their own reputation and the future of their heirs. Still, these companies face a number of ethical challenges. One of the most important of those is to deal family member and non-family member employees even and fair. Another problem is information leakage: it seems that business secrets are more easy to access for outsiders there.

Financial misconduct like fraud and thefts are less likely, accounting restatements or informed trading happen less often in family business than in other companies. The market clearly knows that and thus when an ethical issue still emerges the consequences are usually more severe. This is why hindering ethical misconduct is very important in family businesses. To achieve that you have to consider the elements of the fraud Pentagon.

### 13.4. Reflective Questions

1. What is the difference between being lawful and ethical? Which is more important?
2. Did you ever experience any unethical behaviour? How did you react?
3. Do you think family businesses are more ethical than other companies are? Why?
4. How can you deal with ethical challenges in a family business?



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# ANNEX 1

## National specifications

### Introduction

Among the most prominent issues that differ in the field of entrepreneurial finances, we chose to detect the regimes of taxation. Any country's regime is complex to cover in full; therefore, we include the major types of taxes only: corporation tax, personal income tax and contributions, and value added tax. Similarly, the tax administration and tax audit issues will be neglected from our investigations.

The way in which SME income is taxed, and the different forms of taxation depending on the form of the business or distribution of income, inevitably influence a number of decisions made by the owner of a family business. For this reason, it is highly recommended that the owner-managers familiarise themselves with the certain rules of the country of their operation.

# I. Hungary

## (Judit Sági)

### 1. Taxation: major types of taxes

#### 1.1. Corporation (and dividend) tax

Pursuant to Act LXXXI of 1996 on Corporate Tax and Dividend Tax [hereinafter referred to as the 'Corporate Tax Act'], resident taxable persons include: business associations (such as joint-stock company, limited liability company (kft.), general partnerships (kkt.), limited partnerships (bt.) and other organisations (e.g. foundations, associations); and also non-resident taxable persons with a place of business management in Hungary. Generally the tax year corresponds to the calendar year (however, taxable persons may exercise discretion, especially when it is initiated by the foreign parent company).

Pre-tax profit, determined by applying the tax base increasing and decreasing items set forth in the Corporate Tax Act, represents the corporate tax base. As of tax year 2017, the corporate tax rate is 9 % of the positive tax base. The tax on dividends – as a main rule – is 15%.

#### 1.2. Preferential taxes for SMEs

The private entrepreneur may, if certain statutory conditions are met, opt for flat-rate taxation or Simplified Entrepreneurial Tax (EVA), or for Fixed-Rate Tax of Low Tax-Bracket Enterprises and on Small Business Tax (KATA), or Small Entrepreneurial Tax (KIVA).

A 37% tax rate is applied to the income of taxpayers paying simplified entrepreneurial tax (EVA). Redemption covers the corporation tax, the personal income tax payable on entrepreneurial dividend base and the value added tax.

Taxpayers paying the Fixed-Rate Tax of Low Tax-Bracket Enterprises and on Small Business Tax (KATA) will, as a main rule, pay a specific monthly tax of 50,000 HUF – or 75,000 HUF and if they choose to do so. No corporation tax, personal income tax and national insurance contribution is needed to be paid in this case.

In case of Small Entrepreneurial Tax, the tax base is the net cash inflow to the company plus the personnel expenditures. The tax rate is 13% from 2018; and by paying it, no corporation tax and national insurance contribution is to be paid.

### 1.3. Personal income tax and contributions

Private persons resident in Hungary are subject to tax liability in respect of all their income whether earned in Hungary or abroad (comprehensive tax liability). The tax year is identical with the calendar year.

The Personal Income Tax Act (Act CXVII of 1995 and its amendments, hereinafter PIT) distinguishes between the following categories of income in the case of private individuals:

- incomes to be consolidated: income from activities other than self-employment, income from activities of self-employment and other incomes to be consolidated;
- incomes taxed separately: (e.g. income from capital gains, income from private businesses and income from the sale of movable and immovable assets).

Since 2016 the rate of the personal income tax is 15 percent. Certain incomes, like fringe benefits are taxed differently; and there are tax-exempt benefits as well.

The employees pay contributions for pension (in amount of 10% of their gross earnings), health care (7%) and unemployment (1.5%).

The employee net average tax rate is a measure of the net tax on labour income paid directly by the employee; and calculated as follows:

$$\text{Employee personal income tax and employee social security contributions} \\ - \text{Family Emy Benefits} / \text{Gross Wages}$$

In Hungary, the average single worker faced a net average tax rate of 33.5% in 2017, compared with the OECD average of 25.5%. In other words, in Hungary the take-home pay of an average single worker, after tax and benefits, was 66.5% of their gross wage, compared with the OECD average of 74.5%. Taking into account child related benefits and tax provisions, the employee net average tax rate for an average married worker with two children in Hungary was reduced to 14.5% in 2017 (OECD, 2018).

### 1.4. Value added tax

VAT is charged on turnover at each stage in a production process, but in such a way that the burden is borne by the final consumer. The standard rate is 27% in Hungary; besides, there are reduced rates of 18% and 5% for certain types of goods and services.

Reverse taxation is a specialty in the Hungarian VAT system; in this case, the buyer needs to report and pay the input VAT.

There are exemptions in the VAT system, like: real exemption (to export sales), taxpayer's exemption (for small businesses), and exempt supplies.

## II. Poland

### (Judit Sági and Ireneusz Górowski)

#### 2. Taxation: major types of taxes

##### 2.1. Corporation (and dividend) tax

The 19-per cent corporate income tax is the only corporate income tax. The taxable base is the difference between revenue and the costs incurred in earning it; if the difference is negative, the taxpayer declares a tax loss. In certain cases, revenue may be the taxable base. Dividends – as according to the main rule – are disbursed by corporations with offices in Poland are subject to withholding tax at the 19-per cent rate. Generally the tax year corresponds to the calendar year (however, taxable persons may exercise discretion, especially when it is initiated by the foreign parent company).

##### 2.2. Personal income tax and contributions

Individuals in Poland are taxed on their own income (separately), but married couples can opt to be taxed on their joint income. The tax liability is comprehensive.

There is progression in tax rates: below PLN 85,528, 18 per cent of the tax base, less a basic tax credit of PLN 556.02 is to be paid. Over PLN 85,528, the tax liability is PLN 14,839.02 plus 32 per cent of surplus over the PLN 85,528. The social security contribution for employees is 13.71 per cent of the gross wage; this includes 9.76 per cent pension insurance and 2.45 per cent sickness/ maternity insurance. The employee net average tax rate is a measure of the net tax on labour income paid directly by the employee; and calculated as follows:

*Employee personal income tax and employee social security contributions  
- Family Emy Benefits / Gross Wages*

In Poland, the average single worker faced a net average tax rate of 25.1% in 2017, compared with the OECD average of 25.5%. In other words, in Poland the take-home pay of an average single worker, after tax and benefits, was 74.9% of their gross wage, compared with the OECD average of 74.5%. Taking into account child related benefits and tax provisions, the employee net average tax rate for an average married worker with two children in Poland was reduced to -4.8% in 2017, which is the lowest in the OECD (OECD, 2018).

##### 2.3. Value added tax

The standard VAT rate is 23% in Poland; but a reduced VAT rate of 8% and a super-reduced rate of 5% are applied to supplies of certain food items. Some sales are exempt from VAT.

As an exemption, there is a reverse charge for a certain scope of transactions (e.g. for the sale of electronic equipment).



## III. United Kingdom

### (Judit Sági and Razaq Raj)

#### 3. Taxation: major types of taxes

##### 3.1. Corporation (and dividend) tax

The accounting period cannot be longer than 12 months and is normally the same as the financial year covered by the company or association's annual accounts.

Taxable profits for Corporation Tax include the money your company or association makes from: doing business ('trading profits'), investments, or selling assets for more than they cost ('chargeable gains'). The Corporation Tax rate for company profits is 19%.

Concerning dividend payments, you only have to pay tax if your dividends go above your dividend allowance in the tax year. For the tax year lasting from 6 April 2018 to 5 April 2019, the dividend allowance is GBP 2,000; then, in the forthcoming two years is GBP 5,000. Above this allowance, the tax you pay depends on which Income Tax band you are in.

##### 3.2. Personal income tax and contributions

The tax unit is the individual, but certain reliefs depend on family circumstances.

In the United Kingdom, standard Personal Allowance is £11,850 that is the amount of income individuals don't have to pay tax on. All taxpayers are liable on taxable income (other than savings and dividend income) at the basic rate of 20% on the first GBP 33,500, 40% over the basic rate limit of GBP 33,500 and 45% over the higher rate limit of GBP 150,000.

Concerning the employees' contributions, there are different 'classes' of National Insurance (NI). The type people pay depends on their employment status and how much they earn. The employee net average tax rate is a measure of the net tax on labour income paid directly by the employee; and calculated as follows:

*Employee personal income tax and employee social security contributions*  
*- FamilyEmy Benefits / Gross Wages*

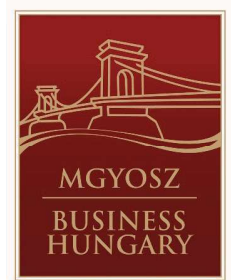
In the United Kingdom, the average single worker faced a net average tax rate of 23.4% in 2017, compared with the OECD average of 25.5%. In other words, in the United Kingdom the take-home pay of an average single worker, after tax and benefits, was 76.6% of their gross wage, compared with the OECD average of 74.5%. Taking into account child related benefits and tax provisions, the employee net average tax rate for an average married worker with two children in the United Kingdom was reduced to 18.1% in 2017 (OECD, 2018).

### 3.3. Value added tax

VAT-registered businesses must charge VAT on their goods or services, and may reclaim any VAT they've paid on business-related goods or services. The standard VAT rate is 20%; but some goods and services are taxed by a reduced rate of 5%, or by a zero rate. Some things are exempt from VAT.

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