

Are Small Family Firms Financially Sophisticated?

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Small family firms (SFFs) are traditionally known to have adopted basic financial products like bill discounting, electronic inter-bank transfers and mortgages. However, some SFFs have also adopted advanced financial products like syndicated loans, leveraged buy-outs, futures, swaps, options and forwards. In this paper, the authors attempt to identify the factors that drive small family firms towards financial sophistication. The study was based on survey data collected from 187 Italian family firms. This summary presents the gist of the study, its findings and implications for family businesses.

Small Family Firms and Financial Sophistication Defined

In tune with the definition given by the European Union in 2003, small business was defined as a business organisation that had:

- (1) 250 or fewer employees,
- (2) Turnover of 50 million Euros or less,
- (3) Assets of 43 million Euros or less.

In addition, the authors defined the small business firm as a family owned firm (i.e. SFF) if it met the following conditions:

- (1) The owner family controlled more than 50% stake in the firm,
- (2) The family was actively involved in making business decisions and
- (3) The CEO viewed the firm to be a family business.

The authors broadly classified financial products into basic and non-basic products.

The basic financial products included bill discounting, electronic bank transfers and mortgages. The non-basic products were further classified into four sub-categories based on the need they served. These included:

- (1) **Corporate Finance:** M&A advisory, leveraged buy-out, debt-restructuring advisory.
- (2) **Cash Management:** short money, managing cash requirements.
- (3) **Corporate Lending:** Syndicated loans, commercial paper structuring and advisory, financial leasing.
- (4) **Risk Management:** forward, futures, options and swaps.

The authors considered a small family firm financially sophisticated within a sub-category if it used a broader range of non-basic financial products in that category.

Factors Influencing Financial Sophistication

Based on the extant literature, the authors hypothesize that SFFs' adoption of financial sophistication is influenced by the following factors:

(1) **The family generation that owns the firm:** Third or older generation SFFs were expected to be more financially sophisticated.

(2) **Presence of a non-family CEO or CFO:** An external CEO/ CFO was more likely to

adopt innovative and sophisticated financial products.

(3) **External Shareholders:** Non-family shareholders represented on the board of directors are more likely to drive SFFs towards financial sophistication. This may happen through adoption of modern capital budgeting techniques and/ or network effects like external shareholders providing access to financial markets and institutions.

(4) **Firm Size:** Within the category, the larger SFFs were known to buy a variety of financial products and were therefore expected to be more financially sophisticated compared to the smaller firms.

Key Findings

In order to test the hypotheses, financial data and other firm details were collected through a questionnaire survey of 185 Italian firms. The results of the statistical data analysis revealed that SFFs were **more financially sophisticated** when it came to their choice of **corporate finance** and **corporate lending products** compared to that in adoption of cash and risk management products.

As hypothesized, **third or later generation**, firms were found to be more financially sophisticated, specifically for corporate finance and lending products. Similarly, the **presence of an external CEO/CFO** made a

significant impact on the SFF's financial sophistication but it was mainly limited to the cash management product category. The presence of an **external shareholder** was influential for driving financial sophistication in corporate lending and risk management product categories. For corporate finance and cash management products, the **large size** of the SFFs positively influenced financial sophistication. Thus, support was found for all the hypotheses but it was specific to different financial product categories.

Practical Implications

Small family firms make use of a variety of non-basic financial products. However, the drivers of financial sophistication differ for each product category. The study's key practical implication for a small family firm relates to its decisions to opt for an external CEO/ CFO and non-family shareholders. For instance, a firm that aims to establish broader connections with large financial institutions and widen the range of financial products it buys would do well to hire an external CEO/CFO. Similarly, weighing its costs and benefits, an external shareholder can be brought on board if the firm goes for sophisticated corporate lending and risk management products. These measures would help the small family firm strengthen its capabilities set to deal with the complexities of financial sophistication.

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