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Role of Capital Structure in Mediating the Effect of Optimism and Fundamental Factors on Small Business Success

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ABSTRACT

This study aim study is to examine and analyze the role of capital structure to mediate the effects of optimism, embeddednes value and fundamental factors for small businesses success in Southeast Sulawesi. The samples are 400 small businesses collected by systematic random sampling. Data is analyzed by partial least squares (PLS). Research results show that capital structure only serves as a partial mediation the effect of optimism and embeddednes value on business success. Capital structure acts as full mediation the effect of fundamental factors on business success.

INTRODUCTION

Capital structure decisions for large and go public companies are easier than small and medium enterprises because large companies have easy access to sources-external funding (financial markets). Otherwise, small and medium enterprises often have problems to access funding sources. As a result the small businesses tend to have relatively smaller long-term and use more own capital and short-term debt in capital structure (Titman and Wessels, 1988; Chittenden *et al*., 1996; Michaelas *et al*., 1998; Frank and Goyal, 2003)

Capital structure affects to increase company's value and may affect the capital structure decisions. Big companies are going public and grow (Modigliani and Miller, 1958). Studies the capital structure in small businesses just start to grow at 1990s. Early studies on capital structure of small and medium enterprises were conducted by Balakrishnan and Fox (1993) in United States and by Chittenden *et al*. (1996) in UK.

Balakrishnan and Fox (1993) and Chittenden *et al*. (1996) have spurred the birth of another study to examine the factors affecting the capital structure in small and medium enterprises and how the capital structure can enhance the success of small businesses in Europe (Thomas, 2008) , Taiwan (Degryse, Goeij, & Kappert, Netherlands, 2009; Li -Ju Cheng *et al*., 2009). Their study found that capital structure of small business is relevant to pecking order theory. Fundamental factors (profitability and age have negative effect on company, tangibility and company size has significant and positive effect on capital structure). While Titman & Wessels (1988), Chittenden *et al*. (1996), Michaelas *et al*. (1999), Ye Zang (2010) in England and Haslindar, Tajur Arifin (2011) in Malaysia found that fundamental factors affect on capital structure to support the theory of agency and trade-offs

Owner and/or manager of small and medium enterprise is other interest field to study in making decision of small and medium enterprises to achieve business success by using various sources of financing. It is because the ownership of small and medium businesses is manager who is also the owner of company. Owner and/or manager decision-making process is affected by perception and basic values of life. The role of culture in decision-making in sector of small and medium businesses is strong. Family enterprise, family tradition and

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group (culture) have very strong effect to psychological factors to make decision. It is because small businesses use more local sources of financing. The negotiation process and decision that occurred to use fund sources come from the local communities that cannot be separated from the manager preference , customs, social, ethical and community cultural . It means that psychological and cultural factors will affect the attitudes and behavior of manager and/or owner and communities in associated with small businesses.

One psychological factor to affect the capital structure and business success is optimism of manager or owner. Heaton (2002), Malmendier *et al*. (2007), and Dirk Hackbarth (2008) found that managerial optimism affects on capital structure. Optimist managers prefer internal funds (free cash) than risky debt and prefer to use debt than equity. Bosma, Praag, and Wit (2000), Jeffrey (2010), Sarwoko, Surachman, Armanu, Jumilah (2013) found that optimism has positive effect on business success.

Culture is known as an important dimension in finance. Culture has been shown to have direct affect on business performance or business success. Mavondo, Nasution and Wong (2009), Agbejule (2011) found companies with strong culture will have a high performance because of ability to control the value to encourage all member organization to achieve goals together.

Chui, *et al*. (2002), Kwok, CCY, Tadesse, S. (2006), Li, *et al*. (2010), Kearney Clom, *et al*. (2012), Zheng, *et al*. (2012) found that culture has a significant effect on capital structure decisions. Company with a collective culture values is reflected by strong values and having lower debt ratio. Company with higher culture of Power distance and Masculinity have higher debt ratio. Lower debt ratio is shown in countries with higher cultural values of power embeddedness.

Financing research on capital structure of small and medium enterprises is interesting. Capital structures of small and medium businesses have difference with large companies. Small and medium businesses have important role in developed and developing countries to develop national economy. They were often more associated with government's efforts to overcome the economic and social problems, namely: reducing unemployment, eradicating poverty, and income distribution.

Small and medium enterprises in Southeast Sulawesi constitute the dominant category at businesses share (BPS, 2012). Total SMEs in Southeast Sulawesi Province are 58,387 units. It consist of micro enterprises 38,393, small businesses 16 826 and medium-sized businesses of 3,168. Small and medium enterprises absorb 725,746 labor forces in 2012 from total 1,060,635 workforces or providing employment about 70% of all workers in Southeast Sulawesi. In terms of capital, small businesses are dominated by equity with proportion of 99.47%, while the debt usage is only 0.53%. On other hand, sales turnover reached 3.5 times greater than the amount of capital used to achieve the turnover. This phenomenon shows that success of small businesses to achieve a turnover is more supported their own capital.

Based on above description, this study aim is to examine and analyze the role of capital structure to mediate the effect of optimism and fundamental factors on success of small businesses in Southeast Sulawesi

2. Literature Review and Conceptual Model:

Business success is one of company goal. Business success may be different based on scale and scope of business. Large and gone public companies use company value as the business success. Adversely, Danielson and Jonathan (2006: 3-4) argues that shareholder wealth maximization is not the purpose of small business. Spence and Rutherfoord (2000) revealed that main purpose of a manager or owner of small business is maximizing the sales and profit growth, because profit is the motivation to start and maintain a business.

Successful concept in business studies that often used to indicate the company's performance is financial measure. Nevertheless, there is no universally accepted definition of a success measurement and business success. Researchers have interpreted the business success in many ways. Walker and Brown (2014) describe the business success of small industries as the success level to achieve the purpose or expected goals. A business is successful if they can increase capital, business scale, results or profits, type of business or management after a certain period of time. Business success as small business goals can be achieved through strategic decisions regarding the source of funds that will be used and invested. Many factors affect the business success of small business venture. Researchers found that psychological (optimism), financial and fundamental factors affect on business success.

Theoretical discourse about company funding decision is commonly called capital structure that will improve the company value (business success). It began to become attention since the proposition of irrelevance of financing decision by Modigliani and Miller (1958), which states that company's capital structure is independent from cost of capital. Therefore, company value is not affected by capital structure, but rather determined by operating cash flow. This proposition is opposed because based on a number unrealistic assumptions (perfect market, all investors are rational, no transaction costs, no taxes). Modigliani and Miller revise their theory in 1963 by incorporating the tax into model of capital structure. It creates proposition that debt will be able to increase the company value, because will receive tax benefits as a reduction of debt. This proposition motivates other researchers to examine the role of capital structure to achieve company value (business success). They produced some theories of capital structure. Agency theory of Jensen and Meckling

(1976) explains that debt usage will create relationship between the companies represented by manager (agent) with all parties that have an interest in company as the owner/principal (banks, creditors and employees). Agency theory explains that debt usage in capital structure will cause agency problems. Agency problem becomes asymmetry due to insider have more accurate information about the company than outsider (Ross, 1977).

Capital Structure theory, agency theory and Signaling theory explained that debt usage in financing decisions will increase the company value (business success). Adversely, DeAngelo and Masulis (1980) states that debt usage also increases financial distress or bankruptcy risk that lowering the company value (business success). This theory is known as Trade-off theory. Pecking Order Theory (POT) from Myers (1984) and Myers and Majluf (1984) also explain that debt usage will decrease the company value. It is because higher agency and bankruptcy costs. Agency and bankruptcy costs can minimize by using internal funds sources. When company funds are not sufficient then, according to POT theory, company should use the debt with lowest cost. It means funding source is retained earnings, debt and equity.

Empirical studies for theories of capital structure trade-off, Pecking Order and Agency Theory has been done in various countries for more than fifty years. The researchers have retested that as pillars of capital structure theory. The findings indicate that capital structure theory is not always consistent from one country to another. Graham and Harvey (2001), Frank and Goyal (2008), Colm Kearney *et al*. (2012) explains that there are differences in effect of capital structure on firm value (business success), and also there are differences in factors affecting capital structure.

Capital structure role to mediate the effects of optimism on business success is based on Literature psychology (Weinstein, 1980) that people are more optimistic towards the achievement of outcomes that can be controlled, because they believe they have the ability to minimize internal uncertainty (March and Shapira, 1987). Furthermore, optimistic people about the outcome will have a high commitment to achieve it.

Manager or owner commitment to company can be seen from their large free cash (Malmendier and Tate, 2007). Hackbarth, Dirk. (2008) explains that greater free cash shows that manager or owner optimism will be even greater because they have cash-free for investments, free cash usage will decrease the cost of capital for company will reduce the debt usage. Lower debt will decrease bankruptcy risk and company will increase the business success. This means that managers or owners optimism with more free cash funds for investment will increase the business success if decreasing the debt usage in capital structure. Malmendier and Tate (2007) found that managerial optimism is consistent with pecking order theory

The capital structure role to mediate the effects embeddednes value on business success is based on theory of embeddedness value. It sees the individual as an entity that inherent in collectivity (Schwartz, 2006). Each individual sees himself as an entity that embedded within an organization collectivity. Individuals identify themselves with group, participating in various activities together, and strive towards a common goal which is reflected by business success.

Kwok, Tadesse, (2006), Li, *et al*. (2010), Kearney *et al*. (2012) found that companies with a strong collectivist cultures are more likely to use internal rather than external sources of funds. It means that companies tend to avoid debt in capital structure. Mavondo, Nasution and Wong (2009) found that strong structural embeddedness will improve productivity, efficiency, and market share. Agbejule (2011) found that companies with strong organizational culture able to control company values and will have high business performance.

Based on these ideas, company with a strong embeddednes value would be more likely to use internal sources of funds to finance investment. This behavior will reduce or avoid debt usage in capital structure. The businessmen will believe that high business success will be achieved through the reduction of debt in capital structure. This means a company with a strong embeddednes value will achieve business success through the debt reduction in capital structure

Capital structure becomes mediator the effect of fundamental factors on business performance (business success). Ming-Chang Cheng and Zuwei-Ching Tzeng (2009) conducted a study to determine the effect of financial quality (fundamental factor) which proxied by profitability, company size, tangibility on leverage and company value and the effect of leverage on company value with different quality of company's value. The variable used is total liabilities, fixed assets, and earnings after taxes before interest, earnings before interest and taxes, tax, and interest. The study found that companies with greater debt positively affect on company value's capital structure which tends stronger when the company's financial quality is also good.

Ramadan and Cheng (2015) found that capital structure acts as a mediating variable because the fundamental factors directly has significant effect on capital structure, capital structure has significant negative effect on financial company's performance, and indirectly the fundamental factors has significant positive effect on financial performance through capital structure. Capital structure in this study only acts as partial mediation.

Above explanation of theoretical and empirical studies become basis to make conceptual framework and hypothesis below.

Hypotheses below are based on the conceptual framework:

H1: Capital structure mediates the effect of optimism on business success.
H2: Capital structure mediating the effect of embeddednes value on business success

H3: Capital structure mediates the affect of fundamental factors on business success

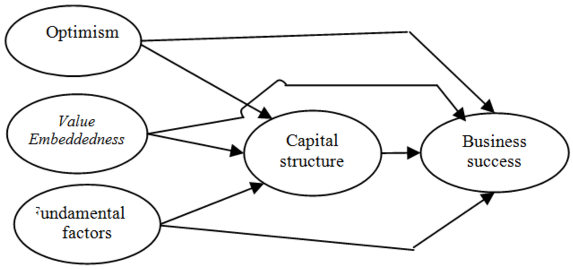

Fig. 1: Conceptual Framework.

3. Research Methods:

This research was conducted in Southeast Sulawesi. The population is all small businesses, based on criteria of small and medium enterprises in Indonesia Law No 20 year 2008. First, the worth (excluding land and buildings) between Rp 50,000,000 to Rp. 500,000,000. Second, Annual Sales (turnover/year) between Rp 300,000,000 to Rp. 2.5 billion. Total population is 19,085, with a margin of error 5%; the samples are of 400 companies. Samples is decided by Systematic Sampling method.

Optimism variable is reflected by two indicators namely free cash and proportion of retained earnings (Heaton, 2002; Malmendier *et al*., 2007; and Hackbarth, 2008). Embeddednes value is reflected by social order, respect for tradition, family security, national security, politeness, self-discipline, forgiving, Obedience, honoring parents and elders, Devout, wisdom Moderate, Clean, protecting my public image and Reciprocation of favors. This refers to theory and research of Schwartz (2005, 2007). Fundamental factors are reflected by profitability, tangibility and size (Michaelas *et al*., 1999; Fama and French, 2002; Frank and Goyal, 2004; Degryse, Goeij, & Kappert, 2009; Cheng *et al*., 2010; Benkraiem and Gurau, 2013; Ye Zang, 2010; Haslindar, Tajur Arifin, (2011; Krasauskaite and Hirth, 2011; Colm Kearney *et al*., 2012). Capital structure is reflected by proportion of short-term debt and long-term debt (Michaelas *et al*., 1999; Fama and French, 2002; Frank and Goyal, 2004; Degryse, Yasdanfar, 2006; Goeij & Kappert, 2009; Cheng *et al*., 2010; Ye Zang, 2010, 2011; Hashemi, 2013). Business success is reflected by sales growth, profit growth and employment growth. This variable refers to measurement of Lee and Tsang (2001), Sarwoko, Surachman, Armanu, Jumilah (2013)

Data is analyzed by Structural Equation Modeling (SEM) based on variance with Partial Least Square (PLS) software. Partial least squares (PLS) software can be used for confirmation and predictions of theories. Wold (1985) states that PLS as "Soft Modeling" is a powerful analytical method because it can be applied to all scale data.

4. Result:

Convergent Validity Test:

Convergent validity is used to evaluate latent variable measurement model with a reflexive indicators by looking at each indicator. Convergent validity test with PLS can be seen from outer loading for each indicator of latent variables. Outer loading above 0.70 is highly recommended, loading factor from 0.50 to 0.60 can be tolerated (Solimun 2010; Ghozali, 2011).

Convergent validity test results showed that all indicators have outer loading greater than 0.70 and value of t statistic is greater than 1.96. This reflects that correlation between the indicators are positive and significant in reflecting the latent variables, as seen in table 1

Composite reliability test:

Composite reliability test is used to examine the reliability value between the indicators of constructs. Results of composite reliability are quite good if the value is above 0.70. The test results of composite reliability in this study can be presented in Table 2.

Evaluation of convergent and discriminant validity and construct reliability for show that indicators as a measure of latent variable is a valid and reliable. Therefore, goodness of fit models can be evaluated by inner model.

Goodness of fit test:

Structural models were evaluated with regard Q^2 relevance predictive models to measure how good the observed values generated by model. Q^2 is based on determination coefficient of endogenous variables. Magnitude of Q^2 is between 0 <Q2 <1, closer to 1 value means that model is better. The coefficient of determination (R^2) of two endogenous variables, Capital Structure (Y1). R^2= 0.3957, Business Success R^2=

0.4252.

Table 1: Convergent validity Test.

Variables	Indicators	Outer loading	T Statistics
Optimisme (X1)	X1.1	0.959733	138.125.021
	X1.2	0.950412	116.672.306
Value Embeddednes (X2)	X2.1	0.419054	2.426.217
	X2.2	0.410073	4.335.723
	X2.3	0.965128	11.776.364
	X2.4	0.926062	13.001.727
	X2.5	0.973131	11.512.412
	X2.6	0.420351	2.413.787
	X2.7	0.94943	11.734.059
	X2.8	0.96192	11.581.393
	X2.9	0.83638	9.363.411
	X2.10	0.957303	1.161.972
	X2.11	0.418101	2.411.475
	X2.12	0.417297	24.117
	X2.13	0.930574	12.188.903
	X2.14	0.937398	11.615.837
	X2.15	0.942535	11.780.517
Fundamental Factor (X3)	X3.1	0.998595	723.861.532
	X3.2	0.998595	723.861.532
	X3.3	0.999297	1.501.413.566
	X3.4	0.998595	723.861.532
	X3.5	0.999297	1.501.413.566
	X3.6	0.996603	31.131.226
Capital Structure (Y1)	Y1.1	0.999814	1.550.510.764
	Y1.2	0.999266	3.217.375.267
	Y1.3	0.997515	899.942.617
Business Succes (Y2)	Y2.1	0.999693	5.645.427.062
	Y2.2	0.999076	1.715.700.877
	Y2.3	0.999384	227.893.322

Source: Data processed with PLS, 2015

Table 2: Composite reliability test.

Variables	Composite reliability	Result
Optimisme (X1)	0.95407	Reliabel
Value Embeddednes (X2)	0.96111	Reliabel
Fundamental Factor (X3)	0.99950	Reliabel
Capital Structure (Y1)	0.99902	Reliabel
Business Succes (Y2)	0.99959	Reliabel

Source: Data processed with PLS, 2015

Based on coefficient of determination (R^2), Q^2 is calculated as follows:

$Q^2 = 1 - (1 - R_1{}^2)(1 - R_2{}^2)$

$= 1 - \{(1 - 0{,}3957)(1 - 0{,}4252)\}$

$= 1 - 0{,}347$

$= \mathbf{0{,}653}$

Calculation result of predictive value-relevance (Q^2) is 0.653 or 65.3%. It means that accuracy or precision of this research model can explain variance of variable business success by 65.3%. The remaining 34.7% is explained by other variables outside this research model. Therefore, the model designed in this study is good or the model have a good estimate value. Based on these findings, model can be used to test the hypothesis.

Hypothesis testing:

Hypotheses tests are done with path coefficients test to know the direct and indirect effects of optimism, embeddednes value, fundamentals and capital structure variables on business success. The effect of independent variables on dependent variable can be known from the value of path coefficient and critical point (t-statistics) in Table 3, 4 and 5.

Test result show that optimism directly has significant effect on business success but optimism does not have not significant effect on capital structure. Identification the mediating type of capital structure will be done by comparing a direct affect of optimism on business success without and with mediating variables (Hair *et al*. 2010: 744) Table 4 shows that direct effect has path coefficient of 0.25448 with t-sig 5513> 1.96 while path coefficient the direct effect at table 3 is 0.25435 with t-sig 5565> 1.96. Because the correlation coefficient values is lower after entering mediation but still sig then capital structure only serves as a partial mediation. Indirect effect (mediation) may also be evidenced by Sobel formula (Baron and Kenny, 1986). The results from

Sobel calculation show z-value of 3.957898 > 1.6690. This calculation shows that mediation testing with Sobel same formula with coefficients approach shows that optimism affect significantly on business success through the capital structure. Coefficient of indirect effect is greater than the direct effect, this means that H1 is accepted (Table 5).

Table 3: Direct Effect with Mediating Variable.

Direct Influence			Empirical Evidence		
Exogenous		Endogenous	Path Coefficient	t- Statistic	Result
Optimisme	→	Capital Structure	0.040301	0.011598	Non Significant
Optimisme	→	Business Succes	0.254352	5.685.331	Significant
Value Embeddednes	→	Capital Structure	0.035811	0.810203	Non Significant
Value Embeddednes	→	Business Succes	0.122017	2.764.293	Significant
Fundamental Factor	→	Capital Structure	0.627332	16,435327	Significant
Fundamental Factor	→	Business Succes	0.008871	0.173473	Non Significant
Capital Structure	→	Business Succes	0.553303	11.556.535	Significant

Table 4: Direct Effect without Mediating Variable.

Direct Influence			Empirical Evidence		
Exogenous		Endogenous	Path Coefficients	t- Statistic	Result
Optimisme	→	Business Succes	**0.25448**	5.513.266	Significant
Value Embeddednes	→	Business Succes	**0.122397**	2.711.374	Significant
Fundamental Factor	→	Business Succes	**0.365974**	7.509.105	Significant

Table 5: Testing the Effect of Mediating Variable.

Hypothesis	Variable Relationship					Path Coefficients	Empirical Evidence	
	Exogenous		Mediation		Endogenous			
H1	Optimisme	→	Capital Structure	→	Business Succes	0.022299	Partial Mediation	Significant
H2	Value Embeddednes	→	Capital Structure	→	Business Succes	0.019814	Partial Mediation	Significant
H3	Fundamental Factor	→	Capital Structure	→	Business Succes	0.347105	Full Mediation	Significant

Test result show that embeddednes value has significant effect on business success but insignificant on capital structure. Table 4 shows that direct effect has path coefficient of 0.122397 with t-sig 2,711> 1.96 while the path coefficient table 3 for a direct relationship is 0.122017 with t-sig 5565 > 1.96. The coefficient of direct effect is lower but still significant. It means capital structure only serves as a partial mediation. Sobel calculation show z-value of 1.9356> 1.6690. It shows that Sobel formula and path coefficient show the embeddednes value has significant on business success mediated by capital structure. Coefficient of indirect effect is greater than the direct effect, it means that H2 is accepted (Table 5) .

Test result show that fundamental factors variable directly has significant effect on business success and capital structure. Table 4 shows that direct effect has path coefficient of 0.365974 with t-sig 7509> 1.96 while the direct path coefficient at table 3 is 0.00887 with t-sig 0173 <1.96. Coefficient of correlation the direct effect is low and did not significant, it means then capital structure becomes full mediation. Sobel calculation show z-value of 3,237> 1.6690. This calculation shows that Sobel formula result is same with coefficients of correlation approach that fundamental factors has significant effect on business success through the capital structure. Indirect effect coefficient is greater than the direct effect, this means that H3 is accepted (Table 5) ,

V. Discussion:

Test results prove the hypothesis that capital structure becomes partial mediating the effect of optimism on business success. It means that small businesses with adequate free cash flow can increase sales. Free cash flow can be used to buy more inventories, pay more workers and provide more adequate supporting materials. The large free cash flow give freedom to managers/owners to increase sales. This study shows that small businesses in Southeast Sulawesi prefer to use using internal funding to achieve business success and prefer to use short-term debt than long-term debt, because short-term debt will be able to increase sales and cheaper. In other words, financing for small businesses in Southeast Sulawesi is more directed to pecking order theory (POT) from Myers and Majluf (1984). The results of this study support the research Hackbarth and Dirk (2008) Kim *et* *al*., (2009).

Capital structure becomes partial mediating the effect of embeddednes value on business success. It means that small businesses in Southeast Sulawesi believe that self embedded value and environment dominated by strong value of manners will be able to increase sales business success. But business success will be slightly increased if the small businesses use the additional short-term debt in capital structure. The facts show that small businesses in Southeast Sulawesi are more likely to use internal funding sources and if it should use debt, small businesses prefer to use short-term debt in form of trade credit that cheap and easily obtainable from fellow entrepreneurs in the region. The results support Mavondo, Nasution and Wong (2009) that strong structural embeddedness increase productivity, efficiency, and market share. Agbejule (2011) found that companies with a strong culture and able to control values in company would has a high business performance.

Capital structure acts as a full mediating the effect of fundamental factors on business success for small businesses in Southeast Sulawesi. It means that small businesses will improve sales business success if the profits increase the company's ability to raise capital through loan at a low cost. The quality of corporate finance (fundamental factor) could further enhance the positive effects of capital structure to business success due the higher profitability (ROA) will decrease risk of bankruptcy. In addition, high profitability and tangibility will increase the company's ability to get a loan with a lower interest rate to reduce capital costs and improve the ability of small businesses to achieve business success. This study findings support Ming-Chang-Ching Cheng and Zuwei Tzeng (2009), Ramadan and Cheng (2015) that profitability, tangibility and size of company (the fundamental factors) indirectly affect on business performance through capital structure. They found that companies that use debt value is greater than companies that do not use debt. Capital structure has positive effect to strengthen company value when the company's financial quality is also good

VI. Conclusion:

Research results show that optimism of small business in Southeast Sulawesi is reflected by free cash. It means greater free cash owned small businesses will increase optimism future business success. Embeddednes value is reflected in manners. It means stronger value of manners implied in business activities of small businesses will easily achieve business success. Higher fundamental factors reflected by profitability (ROA) means that higher company's ability to get better profit will improve fundamental conditions of small business.

Capital structure serves as partial of mediation the effects of optimism and embeddednes value on business success. Capital structure acts as a full mediating the effect of fundamental factors on small businesses success in Southeast Sulawesi. It means that free cash owned, manners and profitability of small business will increase the business success (sales) if companies use the additional funds from short-term debt as a low cost source of financing for business operations. In other words, increasing the success of small businesses will need additional capital from debt.

VII. Limitation and Future Research Study:

This study has some limitations. The study sample is only based on amount of capital and labor for small and medium enterprises based on Indonesia Law No. 20 of 2008. Future research is expected to use this type of industry to know differences in capital structure of small businesses based on industry. This study only looks at physiological, cultural and fundamentals factors to affect the capital structure and business success and not entered economical factor. Future study should uses the economical factors.

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