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The success story of the German Mittelstand has all to do with the dominant success of niche products in global markets. Technical innovation, excellent flexibility and exceptional commitment are the essential reasons for this success. But we sometimes ask ourselves how Mittelstand companies with their limited resources can found and manage subsidiary companies in faraway continents.

In public one seldom hears of problems with the foreign companies of the Mittelstand. This is because in comparison to large groups Mittelstand companies generally tend to have a lower profile in the media and if there is a report on them this is approved by the company management in advance. But a glimpse behind the scenes reveals a different story. Mittelstand companies may well have difficulties with their companies abroad – and once these difficulties are known they are usually serious.

Major mistakes and misconduct in small foreign companies can quickly jeopardise their continuation. But after the name of the foreign unit bears the name of the Mittelstand global market leader, everything is done to avoid the threatened loss of image. It is not uncommon for the means used to absorb the investment budget of a complete year.

It is quite apparent that many of the successful German Mittelstand companies run risks with the management of their foreign companies which are not be underestimated. One can only understand the essential nature of these risks and therefore also only create realistic countermeasures through an understanding of the entrepreneurial commitment with which the German Mittelstand company runs its business.

The owners of Mittelstand companies are entrepreneurs and they attach importance to the fact that they run their business differently to the managers of large international groups. Mittelstand owners are also not investors which follow a rational shareholder value policy. They work for the well-being of the company, their employees and the local community. While company groups focus on the public representation of their success, the Mittelstand managers are more concerned that the company is considered to be a well-managed company in the region.

A well-managed company in the eyes of the Mittelstand especially includes an atmosphere of mutual trust. In this respect the Mittelstand are well aware of their role model. In contrast to managers controlling company groups, the behaviour of the boss of the Mittelstand company is also actually noticed. This is because many of the employees have many years of company service, one has daily contact, and the work is carried out intensively together.

Mittelstand managers are well paid, but they are not primarily motivated by money. An interesting scope of duties, a high level of responsibility and should it be necessary a direct path to the boss all contribute to their long-term service in the company. As everyone does what is required by the task and situation, the Mittelstand does not require guidelines. Guidelines are something for large company groups where staff departments have to be occupied and administrators tend to hide away behind the requirements of the group.

In addition to the fact that Mittelstand understanding of management is characterised by trust, a further significant difference to large group company groups is the clear focus on technical/commercial function. This is because in their capacity as managers the Mittelstand do not maintain a financial portfolio but rather run an actual business. And in their daily business the important priorities are the customer and the product. Sales and engineering work together to repeatedly win customers and provide them with first-class service. Customers and therefore the typical Mittelstand company have no need for an inflated finance department or other staff departments.

The commercial department manages the necessary financial accounting including the annual financial statement and supplies the company manager with the figures he feels are important. The Mittelstand is not generally concerned with 'economic value added' or 'return on investment'. Key performance indicators are rather turnover and natural the profit. Each product must make its contribution to the success of the company. For this purpose there are turnover lists, pre-calculations and post-calculations. A small commercial department can manage this using practical company software. In this process the IT resources in the Mittelstand tend to be lean. Money is only spent on expensive systems if they promise a clear advantage for sales, logistics or production. Even when the importance of business ethics in the company is clearly understood and the head of the department is at least vested with power of attorney or he even has the level of a managing director, the department is consciously kept small. This is because “administration” does not create business.

The dispensation of bureaucratic structures and a highly motivated trust-based organisation are key tools where the Mittelstand companies are more effective in the market than large groups. And why shouldn't one use this recipe for success with a venture abroad? Mittelstand companies are aware that the founding (or also acquisition) and development of a company abroad require a considerable effort. The significant bottleneck here is the personnel resources as in contrast to large companies the Mittelstand companies can only in exceptional cases recruit technical specialists from among existing employees for a longer stay in faraway countries. One consoles oneself with the thought especially in the difficult set-up phase that the lack of local knowledge of such personnel means they would only be able to make a limited contribution anyway. This is particularly true for junior staff more likely to be open for a stay abroad than their older colleagues and managers. At best there is the willingness to send technical specialists abroad in their technical function for a limited period of time. As a matter of principle, however, it is not en vogue for the Mittelstand to send employees abroad for a long-term stay. The widely held view is that in the long term the business is better managed by local managers, people who know the country. The fact that these people are also considerably less expensive than employees sent abroad is a pleasant side effect.

Consequently the requirements placed on local managers are very high. The general manager required for a subsidiary company should have the respectively defined technical or commercial qualifications and have the qualities of an independent entrepreneur. This corresponds to the entrepreneurial commitment of the Mittelstand and is a sheer necessity, i.e. the right candidate must independently develop and manage the business far away from the parent company without the benefit of integration in a large support structure. The recruitment process of the general manager generally takes this profile into account. Whereas his salary may be generous if one makes a comparison in local terms, it is taken for granted that the personnel costs for commercial administration will have to cost less. Therefore the office will make do with one qualified business person and a single person to do the financial accounting, naturally paid at the local salary rates.

If possible – and especially in the set-up phase – the financial accounting and the IT can be outsourced to an external service provider to keep the burden of fixed costs as low as possible. A further potential for saving is the selection of a local auditor who provides his service for a fraction of the fee demanded by an international organisation. But if, however, an international auditing firm is chosen, then a lean auditing format is preferred because at the end of the day the company is not part of large company group. And with regard to the selection of tax and banking services, the local employee at the company will know best what is required in the country and what it should cost.

The personnel resources outlined for the subsidiary company abroad follows the same entrepreneurial principles for the management and organisation which are pursued in the parent company, i.e. a technical and commercial focus concerning entrepreneurial decisions and limitation of the commercial department to the absolute minimum. In comparison to the company headquarters, the foreign subsidiary is much smaller and its structures have to be correspondingly leaner.

Partly due to the lean structure, the Mittelstand entrepreneur prefers not to burden employees in the subsidiary with bureaucracy, but to allow them more freedom. In this process he trusts that the management personnel in place know exactly what they have to do and act accordingly. In other words, the location may be small and a long way away, but in principle it will function as the same way as the parent company does back home. What can one realistically expect from the employees located far away? For the foreign subsidiary to actually function in the same way as practiced by the entrepreneur in the parent company, the local management personnel must correspond to the standards which the employees at headquarters have to abide by at the parent company. Yet while the employees in the parent company are characterised by a training and socialisation process spanning a number of years, experienced management personnel for the foreign subsidiary have to be acquired on the market. On closer inspection it becomes apparent that the required independence abroad even results in higher requirements placed on professional competence, diligence and personal integrity.

In the last decades many countries outside the old industrial regions have made good progress regarding the qualification of their management personnel. However, in the fast growing emerging economies, the Mittelstand entrepreneur has to ask himself what kind of arguments he can offer to acquire the best people. Here it would seem to go against his natural principles to win the competition with international groups by offering a higher salary. The meeting of the existing list of requirements often seems like trying to do the impossible. For example, if the general manager has to be a well-qualified specialist and at the same time have independent entrepreneurial spirit, this will exclude younger motivated candidates who at least in the early years will require a certain level of support from the company organisation. This essentially leaves experienced candidates with professional entrepreneurial skills. But why should such a person wish to continue his career in a small company with just a few employees? In fact there are many indications that important points for this person may be the salary, company car and the title of managing director.

The situation will be similar regarding the selection of the business assistant. If, for example, the foreign subsidiary is a production facility, the business assistant will basically have to cover the full range of responsibility at the subsidiary similar to that required of the head of the commercial department at the parent company. Taking the lean personnel resources into account, the person at the subsidiary will have to manage the accounting, act as controller and treasurer, and also have to be able to competently handle the tax consultant, external IT service providers, and other experts. The Mittelstand company often underestimates this wide range of requirements. And if the parent company is aware of it, the question remains to be answered as to which well qualified person can take up the position. Who will cover this demanding range of duties and given the lean personnel structure of the department is also prepared to take over a multitude of simple office tasks himself?

In general there is evidence to suggest that starting with the choice of personnel in their foreign subsidiaries, Mittelstand companies often do not have the experience and competence required for the subsidiary in combination with the necessary management organisation characterised by personal responsibility and trust.

It makes no difference whether this concerns the commercial or technical department: a lack of competence combined with a "relaxed" management organisation harbours considerable risks. Past experience shows that as well as risks occurring through carelessness, dangers can also remain unrecognised due to a lack of competence and experience. For example, the daily business of the technical department neglects the subjects of occupational safety or safeguards against hazards. In the commercial department, for example, data protection, tax transfer pricing documentation or special customs regulations are not sufficiently observed. If insufficient knowledge of the prevailing regulations leads to these duties not being dealt with, this can lead to a considerable amount of damage. If we take all these conditions into account, it becomes clear that one cannot leave a relatively small company far away from the parent company to its own devices.

Diligence and reliability are virtues which the employees at headquarters have acquired in the course of a training and socialisation process. Someone who turns out to be unreliable will not reach or stay in a management position. It is an open secret that in this respect in some regions of the world other standards are applied. On our holidays we may well appreciate the easy-going attitude of the locals in the foreign country, but in our own organisation this behaviour would be seen as carelessness which could have serious consequences. An example of this could be the conclusion of business transactions which are not fully understood. While this would be a capital sin for a German business person, a number of colleagues abroad like to rely on external advice.

In general the Mittelstand entrepreneur quickly realises that sometimes in a foreign subsidiary there is a different understanding of diligence and reliability. Instead of reacting with corresponding control mechanisms, this knowledge is usually accepted in a broad minded manner as being typical for the country and the management at the subsidiary is allowed to control itself. A common proven tool for self-regulation is the implementation of dual control. Given the low staffing level the effectiveness of this control mechanism is, however, limited by the actual situation. Firstly, the initial supervisory step is missing: whatever the manager, for example the commercial manager, has to sign will due to his high level of operative duties frequently have been prepared by himself so that the item can only be checked by the general manager or production manager. But which of these two is in a position to be really able to evaluate and check the financial transactions of the business operative? Furthermore, if the management style of the general manager is based on hierarchy, there remains the risk that he will not scrutinise further because he may wish to save himself the embarrassment of not being in the know. In fact in many countries the principle of dual control does not usually apply to the boss: the CEO at the top of the company signs by himself. According to the understanding of the country a second signature would put into question the sole management position of the general manager. Experience has shown that the implementation of the corresponding signature regulation at this level is extremely difficult. In addition, one cannot necessarily assume that management personnel you only see a few times a year have the same level of integrity you know from long-serving employees in the parent company. This is because without prejudice to the foreign management personnel one has to accept that one does not know them as well as the employees at home. Apart from that there is the fact that in a number of countries a low level of corruption is common. Usually this so-called petty crime may not be known in detail to the Mittelstand entrepreneur, but in principle will be known for the country in question. In the hope that certain limits will not be exceeded, this is accepted as typical for the country provided the team at the subsidiary otherwise do a good job. This is at least implicitly also a component of the Mittelstand trust-based organisation.

It should now have become clear how crucially important it is for the trust-based organisation to function for the management of the Mittelstand subsidiary abroad. In this process, however, the trust is often questioned from one side, although trust can only function if it is mutual. In fact each manager in the parent company has to ask himself to what extent does he himself enjoy the full confidence and appreciation of the team at the subsidiary. But in this context it should also be considered that in contrast to the day-to-day business at the parent company one doesn't see each other every day. The colleagues in the company abroad do not experience the Mittelstand boss every day and therefore it is much more difficult for them to form an opinion about his integrity and reliability. Instead, the managers from the parent company fly to the subsidiary several times per year for a few days and in this short time try to completely work through their agenda. It is obvious that at the subsidiary one gets to know colleagues differently compared to the daily business of the parent company.

In countries with a bigger prosperity gap than Germany another factor is that the visit from Germany is made using 4 to 5 star hotels and therefore leaves a noticeable impression on the monthly result of the subsidiary. This may well not yet lead to distrust, yet it documents a certain distance between the parent company and subsidiary which is not easy to overcome. Then, when a certain level of petty crime is presumed the question arises whether the own behaviour in the eyes of the employees abroad may subjectively move the boundaries of the tolerated corruption. The trust-based organisation usually provides the necessary freedom for this.

From a rational point of view, one has to admit that many mechanisms of the Mittelstand trust-based organisation do not work with the management of faraway foreign companies or at least take a lot longer until they take effect. To the extent, however, that the function of the trust-based organisation cannot be fully assumed, risks will arise and the controls deemed to be unpleasant will become a reality. In this situation the focus will not be on a systematic risk management. The main control instrument in the Mittelstand is the financial reporting system. As the reporting system orients very strongly to the control philosophy (turnover and profit) of the parent company, a lean income statement is the main component of the at best monthly financial reporting measure. Furthermore, a balance sheet is usually also sent and much more seldom a liquidity report. Regular cash-flow statements are rather the exception with the Mittelstand.

Under consideration of the lean IT infrastructure, the regular reports do not come from a global ERP system, but from a manual or semi-automated written Excel file. The line structure of these reports is highly aggregated or at least analysed in a much aggregated summary. Anyway, normally only limited capacity is available in the parent company for the analysis of the monthly reports. Investment controlling is carried out in parallel and is not at the top of the list of priorities. This is another reason why the contents are usually not questioned. It is also indirectly assumed that the preparation of figures is made according to the same rules as in Germany. Local accounting plans, other booking habits and deviating valuations remain undetected.

If need be they are adjusted in the course of the annual consolidated financial statement. And whether the auditor of the foreign company really sees the necessity for this depends partly on the scope of his audit assignment and also on his knowledge of the German accounting standards. One striking example of the pitfalls of the reporting process is the transition from the income statement of the Anglo-Saxon cost of sales method over to the total cost method used in German financial reporting. In the Anglo Saxon single circuit systems the input materials are usually directly booked from the material store to the order (work in progress). This concerns a booking between inventory accounts so that a material cost is not reflected. Consequently, in the transition to the total cost method the cost of materials has to be retrospectively determined as a residual value from performance, results and the other expenses.

If one considers that the cost of materials in production companies represents the largest cost item, it becomes clear that in the manual determination of such a supposed residual amount for the financial reporting process errors in other expense items will be forgotten. Anyway the line structure of the financial reporting is oriented to the reporting of the control practices of the parent company. But items deemed to be important and necessary in the parent company need not be the same as the facts which have to be observed on a practical basis in the subsidiary. For example, currency hedges relating to orders in Germany are typically made in a single valuation unit. The intermediate resulting book gains and losses are not subject to special monitoring because they neutralise as the order is executed. In countries where the currency is not freely convertible, currency hedging is frequently made on the basis of the flat rate foreign currency requirement as a balance of the planned foreign currency transactions in sales and purchasing. This form of protection clearly represents a much higher form of risk but is often hidden in a collective item included in the reporting.

Also, when the turnover and result are correct in the financial reporting, each Mittelstand entrepreneur should ask himself how meaningful his lean reporting really is and what risks are associated with the manual preparation of Excel files.

The answer to these questions decisively depends on the extent to which the commercial department really understands the working methods of the colleagues in the company abroad. How much does the parent company understand of the processes in the subsidiary company? The commercial support the subsidiary receives from the parent company is mainly concentrated in the founding phase of the company when the legal questions are clarified, the auditor is selected and the lean reporting system is introduced. In contrast, the setting up of commercial systems and procedures is usually the responsibility of the commercial manager as ultimately only he and the auditor are familiar with and can implement the local requirements. In other words: the parent company generally does not set up the greater part of the commercial organisation at the subsidiary.

In later years the business operative from the parent company mostly only visits the subsidiary once per year (or less). He cannot spare any more time and the Mittelstand entrepreneur also has no understanding of the necessity. Along with a courtesy call at the local bank, during these visits the local auditor is primarily consulted in order to discuss the annual financial statement and the management letter. Furthermore, together with the commercial manager from the subsidiary, the planning, sales projections and possibly also individual order results and financial questions are discussed. Any subjects not coming to light in these meetings will continue to remain hidden. The meticulous search for possible deviations and inconsistencies would not be in keeping with the principles of the trust-based organisation.

Basically the parent company is aware that a number of processes in the subsidiary are being handled a bit differently to how they should be handled. But detailed knowledge of these processes is usually not available. In fact, also here one trusts that matters are proceeding in the proper manner. However, the definition of the proper manner can vary greatly between different countries.

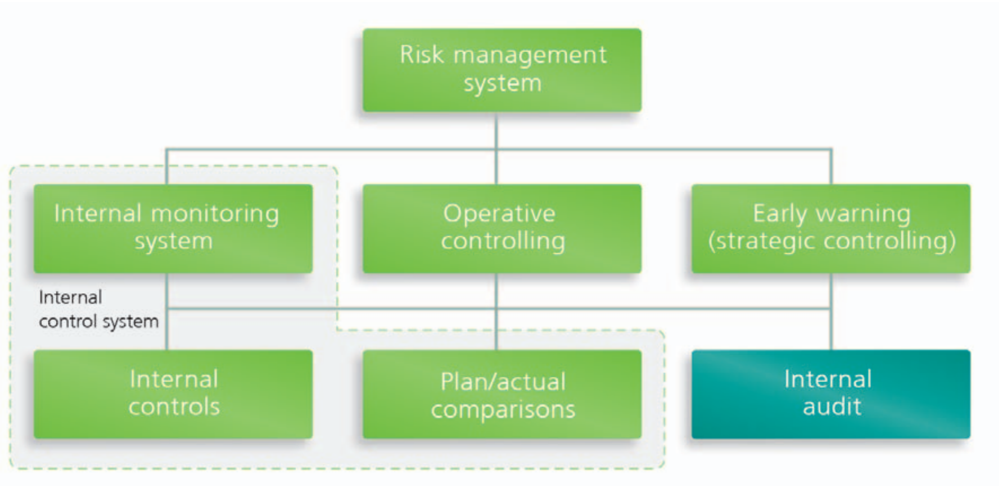
And a number of other differences can be identified in the commercial organisation. With the total cost method and currency hedging two remarkable differences between the commercial systems of the parent and subsidiary companies have already been mentioned. Without attempting to list all of the differences, further points are listed in the following which are typically organised differently in small subsidiaries abroad.

In the process of cost accounting, the components of the manufacturing costs are often deferred very differently. If a regulation does not exist which is valid for the whole group, it will not be possible to seriously compare cost rates or product costs. If changes in inventory also have an impact, the effects on the income statement and balance sheet vary greatly. While nowadays in most German companies in principle a planned, standard or normal cost accounting prevails, in some countries – mostly tax-based – an actual cost accounting is still used. In the case of underemployment this causes the manufacturing costs to rise. In the case of inventory stockpiling, however, the negative effect is only later visible with the revenue recognition.

In various companies non-recurring payments are usually deferred very differently. While, for example, one company discloses a high loss during the holiday period, a different company has distributed the corresponding idle costs to the productive periods. This effect is difficult to overlook and is therefore known in the parent company. It is clear that with these fluctuating results a number of effects can easily be booked which one is reticent to discuss.

While in the parent company there are usually very strict regulations regarding the formation, utilisation and release of provisions, the provisions account in smaller subsidiaries abroad is frequently the place where all deferred items end up. Although the figures are adjusted for the audit at the end of the year, the bookings made in the course of the year are not always transparent regarding an appropriate utilisation or release according to expenses. To the innocent, everything would seem to be in order.

In respect of the handling of payments, in most German companies it is in the meantime usual to make payment transactions once or twice per month. Payment orders are then usually imported via the financial accounting system into an electronic banking system and the payments made are reported back in the same way and booked. In the best case this procedure is concluded and fully documented in the system. In contrast, in many countries payments are still made manually based on forms, printed payment orders, presented checks and even with bills of exchange. Quite apart from the associated disadvantages with regard to productivity these procedures do not reliably provide complete documentation and traceability in the IT system. In reality it requires a thorough paper filing system, which can only be checked through personal inspection. As personal inspection is rather untypical for a trust-based organisation, this opens up undreamed of possibilities for fraudulent acts. These circumstances are promoted by systematic weaknesses in risk management. Company-wide ERP systems tend to be rare. In fact the situation is usually that the internal accounting has grown organically over the years consisting of numerous local financial accounting programs. The operative controlling of the parent company is much more concerned with the company planning, ad-hoc troubleshooting of crisis situations or financial accounting questions with subsidiaries. There is often insufficient time for a planned and systematic discussion about deviations. Strategic controlling in the sense of monitoring appropriate early warning indicators in the different markets and areas with the aid of suitable instruments such as competitor evaluation, trend assessment, etc. seldom takes place systematically.



The same is true for the internal audit. In practice an aversion to internal audits can be identified in Mittelstand companies. The inspection or monitoring of the correctness of business processes is seen as counterproductive to the trust-based culture. The setting up of staff departments and management of internal audits is considered to be an excessive amount of red tape or an investment which is not productive. In this way the company structure of Mittelstand companies differs greatly from that of large groups which have their own staff departments for legal, compliance, company development, risk management and internal audit matters. In the Mittelstand these duties are regularly taken over by the managing directors or other management personnel in addition to their existing duties.

The risk here is not so much the non-existence of the staff departments but rather the gradual lack over time of information and expertise. As well as with the set-up and operation, the difference in procedures between the Mittelstand and listed or group companies, however, is also evident in the founding process. Mittelstand companies regularly reduce the utilisation of external consultants in the areas of law, tax and commerce to the absolute minimum. Managers trust in their own research. Drafts for articles of association are frequently made without external assistance, whereby the task of the consultant is restricted to having a "quick look".

If an acquisition is made of a foreign company or part of a company, the execution of due diligence using qualified advisors is still not yet usual practice. Inspections and reviews of the financial, commercial, legal and tax situation of the target are made using own personnel. As a result it is possible that specialities of the respective country are overlooked. This can lead to serious consequences such as questionable ownership of real estate or machines, costly procedures regarding the termination of employment or a lack of a basis for claims relating to contract defects.

As already indicated, the Mittelstand would be able with just a few specific measures such as the complete use of existing structures or the involvement of external consultants to compensate for its lack of expertise or information, but very often there is – especially in the Mittelstand – a fear of consultants, or, shall we say, scepticism regarding consultants. This admittedly often results from the conduct of the consultant himself with pre prepared "standard solutions" for problem scenarios, the use of incomprehensible jargon and the failure to ask about the exact circumstances from those who best know the details, namely the company management. When high fees are then charged for "standard solutions", the Mittelstand entrepreneur being usually very cost conscious politely rejects the proposals and addresses the problem himself – or in fact fails to address the problem correctly. Apart from the unfortunately frequent consequences for the company, this behaviour from the company management is fully understandable. A rethink to remove the scepticism regarding consultants is also advisable for some consultants. What is required is a sense of proportion, attentive listening, individual solution approaches and understanding for the business and the language of the client. This is the only way to talk on equal terms which can lead to measures which are co-ordinated together and implemented.

Our overview illustrates how the Mittelstand sees itself and the approach it takes regarding the subject of internationalisation and subsidiaries abroad. Numerous differences to listed companies can be identified, whereby at this point it should be emphasised that listed companies are not necessarily more successful. The current example of ThyssenKrupp in Brazil and many others show that there is no one-size-fits-all solution for permanent economic success in foreign markets or that despite an apparent professional approach even listed companies have to fight risks which are similar to those the Mittelstand are faced with. It is not our intention to make any judgement as to which way is ultimately more successful.

Our aim is to highlight important aspects and provide information to help companies prepare for the task of controlling subsidiaries abroad. The next chapter will raise awareness of these issues where we will address the phenomenon of the estrangement of the subsidiary abroad from the parent company. Estrangement is usually the result of a complex process where the previously mentioned aspects regarding the control of subsidiaries abroad come into play.