

# How to stay in the driving seat

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The above information without doubt provides a striking insight into the shaky foundations of Mittelstand instruments used to control foreign subsidiaries. Some entrepreneurs will protest that many of the indicated risks are not present in his company and that the picture presented is therefore blown out of proportion. And how should a Mittelstand company limit such risks anyway? The introduction of bureaucratic structures as seen in large company groups, an inflated control organisation, and even the organisation of internal audits are out of the question for Mittelstand entrepreneurs. Shouldn't one simply accept the outlined risks, regardless of the extent they present in individual companies, as the entrepreneurial risk of doing business?

If the question is one of the production and marketing of sophisticated products, the answer is clearly that if it's no good, we will not produce abroad. The name of the company enjoys a high reputation which has to be protected with first-class products and services.

In commercial matters the answer is less passionate, although here the subject is the financial substance and therefore also the existence of the company. And just as Mittelstand companies in the fields of engineering and sales do not tolerate bureaucracy, also in the commercial field it is possible to establish highly professional and lean structures.

Essentially the following steps should be followed:

- › Worldwide standardisation of the commercial tools
- › Reduction to practical and necessary measures
- › Extensive automation of commercial processes
- › Open discussion of the risks

## Standardisation of the financial accounting

The core area of the commercial activity is financial accounting and here the largest differences are typically between the companies at home and abroad. In particular, there are often differences between countries in the use of financial accounting as a starting point for figures.

Local financial accounting regulations are usually used to explain this. A much more valid reason, however, is provided by the different financial accounting cultures in the respective countries and companies. And it is possible to overcome these. An analysis of what is really essential and important opens up much more room for manoeuvre. First a check should be made of the frequently discussed valuation differences of the different countries to establish if the facts are even relevant. For example, the much discussed amount of goodwill is of no importance with self-founded companies abroad. Furthermore, an analysis is recommended of

the scope of valuations. For example, the costs of the development in many countries can be capitalised, but do not have to be (which is anyway much closer to the cautious approach of Mittelstand companies). As a rough guideline it can be established that many if not most of the relevant choices of valuation can be reduced to a common denominator.

And also the regulations regarding the chart of accounts which exist in a few countries do not represent a real barrier as modern systems allow the dual numbering of accounts and also limitless links between account numbers.

There are also large differences in cost accounting, although the freedom to standardise here is even greater. The legal requirements exist at best indirectly through the necessity of determining the manufacturing costs for the inventory valuation in the annual financial statement. As a matter of expedience the cost accounting should record such manufacturing costs which are sufficient for the accounting standards so that ideally the valuations can be adopted in the balance sheet without having to make an adjustment. An international standardisation of the balance sheet manufacturing costs is usually not really a problem. This is because usually the flexible areas of the financial accounting regulations are so well documented that a uniform international definition can be found. After this requirement has been met, the cost accounting can be organised worldwide completely to take into account the tax requirements of the company group.

The international standardisation of financial accounting takes courage, but ultimately the goal is to turn the traditional world of determining figures on its head. In many companies substantial resources are devoted to preparing figures from a financial accounting system primarily geared to local particularities more or less for the requirements of the company control in the group. However, it is much more efficient to enter the figures directly according to the control requirements of the group. And the few really individual requirements of each country are fulfilled with a low additional cost at the end of the year.

Important adjustments to local financial accounting are in particular valuation differences which arise compared to the German principle of caution. It is also not possible to standardise tax driven aspects. In most countries it is not necessary to channel these through the financial accounting for the whole year, but they can be listed at the end of the year in a special invoice. In terms of the group this is efficient and also enables transparency as it is visible which results from the business are economic and what effects result from the influence of the local financial accounting.

## Important: first of all clean up the parent company

The name “parent company” already gives rise to speculation that after many head offices have decided to address the project of international standardisation they do tend to force their own systems on the foreign subsidiary. What is proudly called a rollout, can often end up a flop.

The financial accounting of German companies usually has to labour with a vast amount of accounts which are based on considerations from the middle of the last century. In those days the chart of accounts were set up before many companies had cost accounting and also material groups in the ERP systems did not exist. If one considers the access possibilities of today with ERP systems, then there are possibilities to get rid of some ballast. An examination of the chart of accounts reveals a further phenomenon that if an account has been created, usually for a person from the top management to have access to some special information, it is carried along until eternity. The large number of accounts in the parent company is already a significant cause of account determination errors. It would therefore be a waste of energy to make foreign colleagues understand this mammoth organisation. In short, before a rollout it is necessary to clean out the chart of accounts.

If the cost accounting is to be standardised worldwide, duplication of the domestic system should be avoided. This is because it is a German phenomenon that cost accounting has developed to become its own science and the connection between its result and the result of the financial accounting remains a mystery to many company managers. In this respect one can by all means learn from abroad. The items which are not present abroad may well with a comparable business model be superfluous at home. In total, we absolutely recommend that the first step is to examine the commercial structures and systems in the parent company and to put these in order.

## Organisation of financial accounting as a management information system

The model for the organisation of a uniform international financial accounting has to be the core element the Mittelstand company uses to control its business. Usually each entrepreneur knows the rules for his business and which factors can influence or jeopardise his success. Sometimes he finds it hard, however, to represent these factors in a few key indicators. It is the art of the good businessman to offer assistance and represent the control concept in the financial accounting while taking into account the requirements for entrepreneurial control and also the legal financial accounting requirements – worldwide. In the end, an efficient business management and control system is also characterised by the fact that it is accessible and

comprehensible to the whole of the management and not only to persons with commercial qualifications.

## Extensive automation of the commercial procedures

The representation of processes in an IT system is often viewed as the main step towards increasing efficiency. And indeed, if one considers the example of digitalised invoices, an important rationalisation step has certainly taken place, whereby a well introduced system already carries out the main tasks of checking invoices and allocation to an account automatically. In the course of a subsequent analysis by the controlling department the electronically stored documents are also available at the press of a button. The often tedious walk to the filing cabinet is now left out.

The apparent advantages of automation, however, should not hide the fact that the real rationalisation is the simplification of the process just as outlined in the passage above. Apart from that the thinning and streamlining of processes is a necessary condition to ensure that international standardisation can even be implemented.

In addition to increasing efficiency, the complete traceability of business transactions is a further advantage of IT solutions. If it is possible to successfully represent commercial processes without media inconsistencies in the IT system, these transactions will also be correspondingly better documented and traceable within the system. This is highlighted by the example that a receipt of an incoming invoice still issues a manual payment order to the bank because the electronic financial accounting and the actual payment order are separate. This means that the actual accounting process can be traced in the system, but that inspection of whether the payment was correctly made requires a personal look at the paper file which is hopefully complete, a traditional task of the audit.

Instead of that it is today possible without great cost that after the posting of an invoice the corresponding payment is triggered directly from within the ERP system, to send the payment via electronic banking to the bank and then using the same method to report back to the company from the bank that the payment has been made and then to post this information almost immediately. This removes the need for the unpopular filing process and everything is immediately documented in the IT system. This serves to limit the possibilities for errors and also removes the possibility of incorrect behaviour. The person who then consciously violates the rules of the installed system runs the immediate risk of being detected and identified.

As a preliminary conclusion one can say that standardisation and streamlining of commercial processes and their seamless representation in the IT system result in efficiency and

transparency. Efficiency because the figures are produced quicker, one does not communicate at cross purpose and standardised systems are easier to maintain. Transparency is established as one knows what a recorded figure really stands for and because the documents for the figures are fully available as and when required.

## Guidelines, but the right way

In spite of a reluctance to embrace guidelines, each department has a number of rules which have to be observed. In particular in positions connected to essential and existential risks, one should not dispense with the formulation and enforcement of guidelines.

Such subjects are, for example:

- > Signatory rules
- > Financial transactions
- > Protection of the data network
- > Insurance

In principle, a guideline should only include what one is prepared to enforce. Therefore the motto "less is more" applies. In order to ensure that guideline can be enforced, they must be easy to understand, i.e. they must also be comprehensible to non-experts. Items which are not understood can hardly be enforced in the foreign subsidiary which is far away. And guidelines which are not enforced are not needed. These are facts which immediately come to mind for engineers on the subject of occupational safety.

## Discussion about residual risk

It would be naive to believe that an automated financial accounting and a pair of guidelines will allow us to deal with all risks. It is therefore important within the organisation to make risk management an important theme. Of course risk management in Mittelstand companies must not be allowed to function as a cover up for the company management in relation to advisory boards and shareholders. It is more about creating a culture where there is open discussion about errors and risks so that this knowledge can be used in operative processes and perhaps even written down in guidelines.

## Transparency and efficiency

In the previous sections it should have become clear that commercial risk management is not just the establishment of bureaucracy, but also about the organisation of efficient and

transparent structures. This enables the Mittelstand to reach a degree of professionalism which is cannot be achieved by larger company groups, as the number of the companies in Mittelstand company group is limited. In addition, new companies are not continually purchased and a different company disposed of. And finally the commercial department is not busy with some capital market reports. What the company knows is usually also available knowledge for the shareholders.

In other words, the presented measures are feasible for the Mittelstand and much more important is the fact that they are worthwhile because a high commercial quality and flexibility can be achieved with far less tools than in a large company group.

We must not, however, overlook the fact that the way to achieve this, at least in the initial stages, is not all that easy. And it is here that an international legal and auditing firm can provide good services. This is because often the companies themselves do not know the best course of action. Once they are informed about the possible options, the fear grows that their own system which luckily offers a degree of stability is at risk before the new solution has been understood. And one cannot hide the fact that such a project carried out properly can take some years to achieve. It is therefore recommendable to co-ordinate with auditing experts to draw up a clear project plan and to work together with the commercial personnel of the foreign subsidiary to slowly work through the plan. In addition to the activities described above, there is a further effective tool to monitor and control of foreign subsidiaries. This concerns the improvement of co-ordination with the auditor in the course of the audit of the annual financial statement.

### **Audit of the annual financial statement – an effective instrument to control the company**

In the preceding chapters the role and possibilities of co-operation with the auditor regarding the improvement of the monitoring and control of foreign companies was touched upon several times. In the last section of our analysis we would like to look more closely at this area and demonstrate the potential for improvement which can be generated especially in connection with the audit of the annual financial statement. The advantage here is that particularly in Mittelstand companies a trusting co-operation over many years exists with the auditor. Due to a lack of pronounced staff departments, the auditor traditionally takes on an important function in the Mittelstand company as a respected consulting partner of the entrepreneur or company management in many questions concerning the management of the company. Due to the many years of experience in consulting and auditing the company the auditor has a good overview of the company and its structures, yet he remains a third party, i.e. he is not directly a member of the company management.

Together with his experience which is also the result of having audited other companies he can use his independent position without the big risk of being blind to the company's failings to be an advisor to the entrepreneur and an understanding sparring partner. In addition, there is the point that in the last 15 years, i.e. since the passing of the law on control and transparency within company activities, auditing practice, as a result of spectacular business collapses, has continued to develop intensively. As before, the modern audit of the annual financial statement includes the traditional elements of financial accounting, i.e. the items on the balance sheet and income statement, but in addition in particular there is the auditing of the internal control system, the risk management system, the IT and the characteristic business transactions of the business model. Then there is assessment of the quality of the management information system, the reporting and assessment of the continued existence of the enterprise. The audit of the annual financial statement thereby touches nearly all areas where in the previous chapters a potential for improvement was outlined with a view to the monitoring and control of foreign subsidiaries.

The following specific areas can be identified:

- › Improvement of the quality of the information in the annual financial statement concerning the individual subsidiaries. The requirements for external financial accounting and auditing vary from country to country. For example, the content and scope of the preparation of the local annual financial statement varies together with the scope of the statutory audit requirement and requirements regarding audit reports. Bearing this in mind it is advisable to agree definite uniform reporting standards with the auditor of the annual financial statement including an understandable transition of the local reporting over to the group reporting (HB II). In addition, it should be agreed with the auditor of the annual financial statement that important business transactions are explained and the assets, financial position and result of operations of the subsidiary company should be thoroughly analysed.
- › Reduction of the deficit of control and information resulting from the lack of internal audits through agreement of supplementary or additional audit actions which are additional to the "standard" audit of the annual financial statement. These audit actions can be concerned with the quality of the local management, the scope, content and application of the operations-related control instruments used in the subsidiary, the compliance of the business processes such as the conclusion of contracts with suppliers, customers or employees and a review of the security of important company assets such as real estate, buildings, machines, etc.

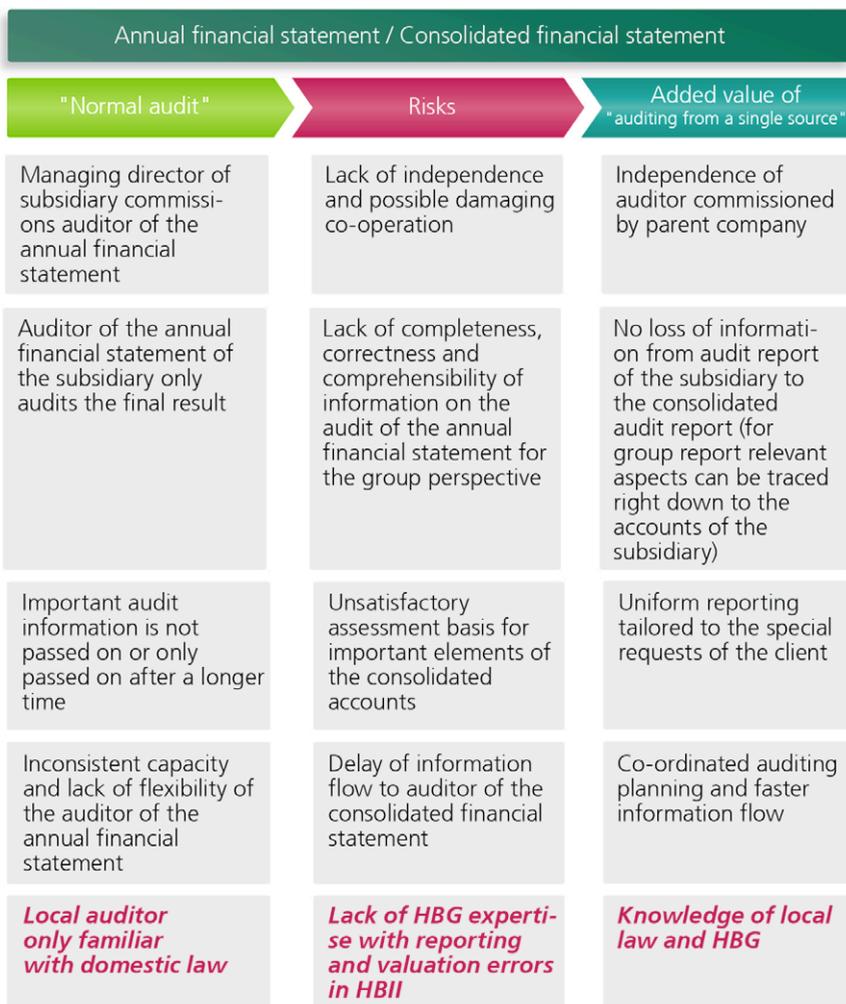
- › Implementation of monitoring and preventive measures concerning corruption or fraud. This may include the following random audit actions:
  - » Correctness of travel expense claims of management personnel,
  - » Appropriateness of remuneration structures for personnel,
  - » Origin of contract partners in the area of purchasing,
  - » Reliability of implementation of scrapping activities,
  - » Scope of involvement of closely-linked persons in important transactions in the subsidiary,
  - » Independence of important third party partners such as the notary.

As a result, it is possible to reduce or even remove numerous weaknesses in the monitoring and control of foreign subsidiaries through a “fine-tuned” audit of the annual financial statement. However, the execution of such a “fine-tuned” audit of the annual financial statement places high demands on the auditor of the annual financial statement. These primarily concern the availability worldwide of qualified auditors for the various tasks.

A further important aspect relates to the question of how a worldwide audit of the annual financial statement should be organised. Does it make sense that in each country different local auditors prepare the respective annual financial statement or are there good grounds for arguing in favour of a worldwide audit of the annual financial statement from a single source? As we have already established, the uniform assessment and valuation of the facts at the local and national levels (naturally under consideration of the particularities of the respective country) and the same level of knowledge with a continuous unhindered information flow between the parent company and subsidiary are important factors with regard to monitoring and controlling of foreign subsidiaries. These aspects are often made more difficult by the fact that the local audit of the financial statement and the audit of the consolidated financial statement are carried out by different companies.

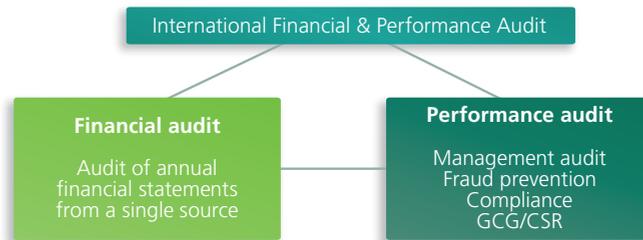
Therefore it makes sense to commission a single international auditor for the respective national financial statement and for the audit of the consolidated financial statement (or voluntary consolidated financial statement) as this will provide a uniform perspective according to HB I and HB II. This is the only way to uniformly assess in total business transactions, balance sheet and income statement items. If one separates the two functions of the local audit and the group audit, there is a risk that the auditor of the consolidated financial statement will depend too much on the results of the local audit, i.e. substantial questions will not be asked about its preparation. In addition, the information flow and the information speed is seriously compromised, without having to mention translations not carried out of the local reporting, which leads to a lack of information.

The following graphic illustrates this situation and shows the added value of the group-wide “audit of the annual financial statement from a single source”:



## The Rödl & Partner International Financial & Performance Audit

Against this background, in recent years we at Rödl & Partner have systematically expanded our auditing practice with an orientation firmly towards the requirements of German Mittelstand companies with international operations. This has resulted in our Rödl & Partner International Financial & Performance Audit.



Based on the understanding of the company gained through the audit of the annual financial statement and its legal and economic circumstances we integrate internal audit-like actions in the areas of management audits, fraud prevention and compliance in our audit activities of the annual financial statements. This allows the individual definition of the scope and depth of the audit to take into account the requirements of the client with a uniform approach worldwide.

The main auditing areas of such a performance audit can include the following:

Management audit	<ul style="list-style-type: none"> <li>&gt; Management organisation</li> <li>&gt; Management instruments</li> <li>&gt; Management activity</li> </ul>
Fraud prevention	<ul style="list-style-type: none"> <li>&gt; Purchasing</li> <li>&gt; Sales</li> <li>&gt; Personnel</li> <li>&gt; Inventories</li> <li>&gt; Travel costs</li> </ul>
Compliance	<ul style="list-style-type: none"> <li>&gt; Labour law</li> <li>&gt; Data protection law</li> <li>&gt; Anti-trust law</li> <li>&gt; Trademark, copyright and patent law</li> <li>&gt; Environmental law</li> </ul>

The **Management audit** starts with the management culture of the company and taking into account the business model of

- › the potential to improve organisational conditions and
- › the available control and planning instruments

should identify, for example, the operative or strategic controlling and risk management system. In addition, prompt informative internal company reporting should be established with the company management.

Starting points here are the implementation of processes relevant for an internal control system such as

- › the principle of dual control
- › monitoring of liquidity and
- › adherence to checklist of business transactions which require consent.

Corruption, embezzlement and other damage to the company assets are often only possible if existing internal controls are bypassed. Such weak points should be identified in the course of **Fraud prevention** audit actions before damage takes place.

Examples of audit actions for fraud prevention are

- › audit of travel cost documentation,
- › audit of actual existence of fixed assets,
- › screening of borrowing business relations,
- › audit of personnel accounts for irregularities with payments and
- › audit of contract and service content with business partners, etc.

**Compliance management** describes the task of the company management to meet the legal, contractual or other obligations in the company through appropriate measures. In areas which are particularly sensitive for the respective company in the course of a compliance audit structures can be defined for a functioning compliance management system.

The observance of important legal and company requirements is checked using a compliance matrix. The individual points of the matrix should be sustainably ensured through contact persons and training sessions in the company. If required, the Rödl & Partner International Financial & Performance Audit can also include further audit elements such as corporate governance and corporate social responsibility.

The aim is to develop and implement an auditing profile which is suitable for the background of the respective client.

The argument of cost which is frequently mentioned by the local management of the subsidiary will not convince here due to the fact that a later clarification of any irregularities or even manipulations will cause costs which are considerably higher without mentioning the worst case of lasting non-pecuniary and pecuniary damage.

The Rödl & Partner International Financial & Performance Audit is a distinct and unique product. The basis for this range of services is the special structure of our company which for more than 30 years has lived a multi-disciplinary approach to determine its own form of internationalism. Our four areas of auditing, tax, legal and corporate consulting are not isolated from each other, but are inseparably interlocked. Many of our consulting and auditing products attain their special value through multi-disciplinary co-operation. A typical example of this is the International Financial & Performance Audit which is made possible through the co-operation of auditors, lawyers and IT consultants. Further examples involve legal, tax, financial, commercial, environmental due diligence services "from a single source" and our compliance services. The character of our international structure makes it clear that we are not a network of independent companies, but are based in Germany and present in 40 countries with our own branch offices. This gives us the same structure as our German clients with their international operations. We know how they tick and we are tuned in to their needs.