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Birgit Suberg *Editors*

Topics of Family Business Governance

Insights on Structures, Strategies, and Executives

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Editors

Topics of Family Business Governance

Insights on Structures, Strategies, and Executives

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Preface

The benefits of a board institution, even for a privately held family-owned enterprise (FOE), are well-documented. Consequently, there is an abundant literature on why and how to design a board structure for FOEs. Certainly, the structure of the institutions of governance is important. But, eventually, the contribution by the board to the development of the company depends on structure, people, and processes. The people involved are particular in each and every situation. The few recommendations possible are typically included in the guidelines for structuring the governance in general. Very limited research is available on the processes of a board. The most important element of the process (apart from frequency and duration of meetings) is the topics dealt with. Which are the issues where the contributions of the members can make a difference? In this volume, we reflect on these topics. This is not a piece of systematic research, but reflections from practitioners working in the boardroom.

For some years, the editors wrote a column for the monthly issues of the *China Family Business Review* on topics of governance. The editors are proud that Joseph H. Astrachan, Claudia Binz Astrachan, Andrew Keyt, Laura K. C. Seibold, and Torsten M. Pieper not only contributed to the said column but also to this book. Of course, these columns dealt with the practice of governance in Western countries, the practical experience of the authors on boards of FOEs. Here, this empirical insight is also augmented by solid research on this topic. Such an endeavor can never be exhaustive. The most regular issues are addressed, most of which are of the essence at some point during the development of the FOE.

Friedrichshafen, Germany — Hermut Kormann
Shanghai, China — Birgit Suberg

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Part I

The Design of Boards for Comprehensive Tasks and Efficient Processes

Introduction

Hermut Kormann and Birgit Suberg

This booklet covers the most important topics in the governance of family enterprises.

Any organization will typically be planned and developed by first designing the structure, then staffing the structure with people who then initiate the processes. That is also the way a new or revised governance system is introduced in an enterprise. In this context, we understand governance as a system to "Lead the leadership" (Foucault). The efficacy of the governance system is, however, determined in the reversed sequence of priorities. Just the processes of the governance institution have an impact on the leadership of the enterprise. These processes of course depend on the actors involved—on their intentions, their power, and their capabilities. The objectives for exercising influence—as the basis of their intentions—as well as the power depend on the structure of the system. Therefore, the processes are decisive for the effects. Whereas there is an abundant literature on the structuring of governance systems, the question of selecting the right individuals for the available roles is rather neglected in the research and on the processes, there is hardly any publication to be found. The reason why the processes are omitted is to some extent understandable and almost unavoidable: They could only be described and analyzed by participating in the meetings. But researchers are hardly allowed to participate in meetings of boards.

Now, our basis for this reflection is exactly this life experience of board meetings. The authors have been members of well more than two dozen boards in large and small enterprises—with few exceptions all of them boards of family enterprises—for over more than three decades. Parallel to this activity as a practitioner, he has done

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research projects on governance in family enterprises and participated in numerous workshops and discussion groups focused on improving the practice of governance. This theoretical perspective sharpened the capability to observe the real-life actions and to draw meaningful conclusions. Thus, the following essays are based on solid involvement in the available theory but are not a piece of theoretical research. They are a record of practical reflections.

While emphasizing the similarity of family enterprises across regions one has to underline the enormous diversity within this type of enterprise. There are small and large ones, young and old ones, those owned by one shareholder, and those owned by a large group of shareholders. Among the different criteria which could form a typology, the age might be the most important specification. Age has a certain correlation to the size and complexity of the business activity as well as to the number of shareholders. We, therefore, structure this collection of essays in a loose order along the timeline of the age of the enterprise. Some of the topics are relevant primarily in a certain phase of the development of the enterprise. Thus, we start with the early phase of the development and move on to the mature, large, multi-generation company. And it is, of course, possible to choose just single articles for reading. Hopefully, the content of one chapter raises the curiosity to have a look into other essays, too.

The topics are selected according to the likelihood and frequency of their appearance in the agenda of a board. That means we do not intend to describe each and every potential theme which could be addressed in board meetings. Reflecting on these topics should be a promising way to design and improve the efficacy of the whole governance system.

We break down the chapters into broad segments of:

- Governance system: how to structure a board
- Strategy process: important aspects of presenting, reviewing, and discussing strategic issues
- Topics of strategy with an introduction of the big questions on strategy which should be discussed by all shareholders and followed by the generic issues from profit to crisis
- Some important aspects on leadership development both in the context of family succession as well as in the context of non-family executives including an outline for the remuneration system

Exploring the Topics of Governance

Hermut Kormann and Birgit Suberg

Governance is one of the buzzwords in modern management. There are many articles, commission documents, and legal stipulations to define the system of governance in public companies. In the realm of family business, there is almost complete flexibility to design one's own concept of governance which fits in with the needs of the owners and the management. There are many concepts categorizing and specifying the various types of governance prevailing in family businesses. Here we try to work out the common features of all advising boards. To this end, we describe the essential issues which typically emerge in the discussions of a board from time to time. These are topics such as:

- What is the situation of the family and of the company? Which targets can we dare to pursue? What are the urgent needs of the company?
- How to balance profits and growth?
- How to cope with a crisis?
- Can we stay independent?

The monitoring of the current financial data versus the previous year or budgets is just a basic function of governance. This serves to keep in touch with the prevailing trends. But this number checking is not really decisive for shaping the future development.

The first step when discussing the future is to understand the situation now and this requires an understanding of the past and how it led to the current situation. A family business has two circles: the family and the business. Each one has its own

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situation and requires a specific perspective. The questions concerning the family are known well. Are the relationships stable? Are there just the normal health problems? Are the children on the way to being responsible individuals? We know what is important, but nevertheless these questions need sensitivity and attendance. A stable development of the family is the prerequisite for addressing the situation of the business. With a crisis in the shareholding family, one would not have a reliable basis for a business strategy.

The analysis of the situation of the business requires a business-relevant experience. There are always two sides to be considered: What is and what is not? The question "What is?" should be concentrated on what is really important for us: what carries the business and what the indispensable basis of our success is. "What is?" hovers around the quest of being important for some customers. Who needs our products and services and why? Which activities generate the famous 80% of our profits? Which are our development projects for the next decades?

The "What is not?" questions are as interesting and relevant as the "What is?" questions. Who does not buy our products and services? Which conceivable substituting technology are we not engaged in?

Then moving from the current situation to the potential futures of your company. The task is not to specify a "strategic plan" which is the action list for the next couple of years. It should be only a compass to indicate the overall direction; where is the true north we are heading to? On the way, each company and each owner family will come to some crossroads. For each hiker, these crossroads are unique experiences. One does not encounter the same crossroad twice. Nevertheless, for the whole category of family companies, the crossroads are fairly similar. Our endeavor is to describe some of these crossroads in more detail and to weigh up the options relevant in the search for a viable path. Some of these crossroad dilemmas are:

- Who should succeed the owner?
- Can we stay independent or should we go public or join forces with someone else?
- Should we diversify?
- Should we go international?

Again, in these questions quite often it is not possible to say what should be done. But in most cases, it will suffice to define what not should be done. To find out what can be done and what must be avoided purely considering the issue is not sufficient. One has to reflect on the question with interested and experienced partners. That is, by the way, one of the benefits of governance: A platform and a need to reflect on important questions in a group of knowledgeable persons who have a close interest in the family and its business.

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Modules and Tasks of Governance

Hermut Kormann and Birgit Suberg

1 The Relevance

There are many approaches to define the essence of corporate governance. For us, the most comprehensive and plausible description is given by the French philosopher Michael Foucault: Governance as leading the leadership of the organization. Each president, CEO, top management team needs to report to someone or an institution and needs to be monitored and evaluated. This is what governance is designed for.

However, in a privately held FOE, the right of being reported to can be allocated to various institutions:

- Major rights might be retained by a managing shareholder as CEO.
- Some important rights—such as appointing managing directors or defining their remuneration—might be retained by the shareholder assembly.
- A majority shareholder might traditionally exercise a special influence whether formally regulated or just informally developed.

The literature on governance has therefore tried to categorize certain types of boards. This is one way to handle the variety of concepts one can see in reality. We prefer to specify the modular elements of a comprehensive governance system. The functions and authorities of the various governance institutions are then defined by selecting the authorities in terms of these modules. Ideally, these elements are chosen in such a way that each element is mutually exclusive versus the other elements and

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altogether they comprehensively describe the whole system. To this aim, we propose the following categorization.

2 Statutory Rights and Obligations for Processes Which Are Based on Law or Shareholder Agreements

Legitimization of Activities of the Management or the Shareholders
The legitimization function must not be degraded as a pure "rubber stamp" formality. These acts include a final verification of the legality and justification of the approved action.

3 Monitoring the Activities of the Leadership and the Development of the Company

3.1 Monitoring as the Right to Ask for Reports

Monitoring is a term covering various activities such as receiving reports, observing, inquiring, and verifying. Monitoring serves different purposes.

3.2 Monitoring the Situation the Company Is in and Its Development

Which are the threats and opportunities and therefore the challenges which the company faces?

3.3 Monitoring the Compliance

Is the organization respecting the laws and the norms of ethics? Obviously, this monitoring cannot consist of checking each relevant action of the management. Monitoring the compliance is primarily based on setting the standards and auditing the established procedures within the organization.

3.4 Monitoring the Performance of the Management and Evaluating the Fit Between Person and Task

Monitoring allows the drawing of conclusions regarding the performance of the management. The evaluation starts at the objective development of the company in absolute terms and relative to the industry. This is complemented by an assessment of the extent to which additional opportunities could have been deployed. This, however, is a highly subjective element. The difficulty is, of course, that the current

performance might be based on decisions and events made some time previously. In any case, an unsatisfactory development requires corrective actions. The ultimate conclusion evaluates the capabilities of the persons in charge and whether they match the future requirements. New challenges might necessitate a new approach. This evaluation implies weighing up the experience and known competencies as well as limitations of the person currently in charge against the expected competencies of a new candidate. These are the most critical but also the most important decision in the governance process.

3.5 Monitoring Leads to Structuring the Processes of the Ones Who Report

Perhaps the most important effect of monitoring lies in the indirect consequence of structuring the communication between those who have to report. Our research gave clear evidence that in medium-size companies the top management team (TMT) has a very informal, unstructured pattern of communication. Such informality has advantages: Close contacts, openness, trust that each member "brings to the table" what needs to be discussed. However, this pattern leaves gaps: Too much ad-hoc dealing in operative issues, no persistence in following up certain issues, neglecting long-term issues, avoiding uncomfortable issues. As soon as a TMT has to report to a supervising institution, such a team applies formal meetings with structured agendas and protocols. Reporting is a structured communication which necessitates a structured preparation. This is a very beneficial side effect of the board which improves professionalization at the level of the TMT.

4 Directing the Management

Directive leadership is based on official, statutory authorities. It is based on one of the following initiatives, which require such authorities.

4.1 Outright Instruction

It is important to note, however, that between a board and the top management team an instruction would be an extraordinary, critical intervention. At these levels of authority, interventions of indirect leadership are usually more appropriate (see below).

4.2 Authority to Approve or Reject Proposed Decisions

This covers the list of approval rights on extraordinary expenses and investments or on actions with increased risks or on purchases and actions where the personal interests of an executive could be involved.

4.3 Conflict Resolution in Case of Disagreements Among the Direct Reports

Having categorized the statutory-based Government activities in the previous section, we now address those activities which hardly can be fully specified by stipulations in a shareholder agreement. Their appropriate performance is solely based on the competence of the actors. The most important set of activities can be summarized under the term "Indirect Leadership." Indirect Leadership provides orientation in order to enable the actor to find the right route of action himself or herself.

5 The Instruments of Indirect Leadership

5.1 Self-Steering

Autonomous orientation to the set objectives is one element in indirect leadership. However, this orientation does not come naturally and it cannot be taken as given. *Objectives* have to be agreed upon, the discipline to follow these objectives by burdensome efforts needs to be instilled by professional work attitude. *Incentives* are an important cornerstone to establish targets and reinforce the alignment to them.

Other elements employed to foster self-steering are:

- Stipulation of legal responsibilities.
- Peer group control, e.g., by colleagues.
- Narratives for sense-making.
- Public recognition of achievements.
- Any instrument of motivation.

There is a surprising dichotomy between the substantial, "hard" impact of self-steering on the results of the TMT activities and the fairly "soft" instruments to support self-steering.

5.2 Cooperative Opinion-Forming

Integrating oneself into the shared process of a task group is one of the most effective means of governance. In Germany, the company law stipulates for the most

frequently chosen corporate legal entities the shared and joint authority and responsibility for running the company. This requires that the top management team takes decisions jointly.

This principle of cooperating is one application of the general principle: Two heads are better than one head. One head or one pair of eyes cannot "see" the own blind spot. A group provides a spectrum of diversity in perspectives and increases the likelihood of observing more facts.

At the same time, these shared processes can form an impediment against deviation from set targets for selfish reasons. The two-head principle is one of the very basic elements in any Internal Control System.

5.3 Context-Based Steering

The next level of Indirect Leadership follows from intensive cooperative opinion-forming. When this leads to reflective, more general conclusions then these can be formulated as maxims for future, similar, decision-making processes.

For example, the rules for financing are such maxims. Or the limits for accepting risks of losses.

Such maxims may be fairly specific and prescriptive: they set only the boundary conditions within which the actors can define their own decision.

5.4 The Competence-Based Versus the Authority-Based Governance Functions

In the literature on governance, it is common to differentiate between powerful boards and boards which have only an advisory role. The latter is then qualified as an institution of limited importance. On the contrary, one needs to emphasize that in the ideal board most of the discussions can be considered as Indirect Leadership and advisory. Definitely valuable input to these elements require more demanding professional and communicative skills. It needs a lot more leadership experience to perform Indirect Leadership than to give an instruction.

5.5 Advisory

The most generic form of intervention in a board is the advisory function by the outside, non-executive directors versus the executive directors. Advisory is exclusively based on competence. It implies that one party—the management—seeks advice and others are able to give advice. Advice given by a board member might often lead to the deployment of professional advisors who perform an extended consulting project.

In the limited time span available in board meetings issues can only be emphasized, assumptions can be reflected upon, options can be visualized. This

kind of advisory is not about the deep-dive for finding root causes and problem-solving.

However, the true value-adding board is the one that raises a good question for further reflection in a vital issue for the family or its enterprise.

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One-Tier and Two-Tier Boards

Hermut Kormann and Birgit Suberg

1 The Relevance

Both China and Germany have the legal concept of a two-tier board. Whenever in Germany one is not satisfied with the performance of a board in general, then the question arises as to whether the one-tier concept is preferable.

It is plausible to pose this question, as in most of the other legal jurisdictions the one-tier board is the standard, and in some states, one can opt for either form. We have participated as members in both board concepts. Before we share our experience and analytical observations, let us review the design of both types and the pros and cons as they are proposed in discussions on that topic.

2 The Basic Design

The one-tier concept means that the board is formed out of members of the top management team, such as CEO, CFO, and one or two other directors, as well as non-active directors from outside the company. In the two-tier system, the board consists of non-active-board members only.

In the two-tier concept, there are two separate governance institutions. The management team is responsible for managing the company. The management has the responsibility to design initiatives for developing the enterprise and for augmenting its value—in short: the "value creation" side. The board has the task

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of “value protection”. The modules of this “value protection” are described in chapter “Modules and Tasks of Governance”.

In the one-tier board, there is one institution, the board, which is the top executive unit of the company. This institution is formed by executive members and outside or non-executive members. The executive members from the management team. This means there can be members of the management team who do not belong to the board. The non-executive, outside members are typically in the majority.

Here we are skipping the concept of chairman/CEO-duality, where the chairperson of the one-tier board is at the same time the CEO. This concept eliminates the supervision of the CEO. It can only be explained by traditions in the American constitution and corporate law—and even then, it is difficult to associate any advantage with this concept.

3 Some of the Arguments

The protagonists of the one-tier system are primarily to be found among outside board members.

They argue that the one-tier concept entails a deeper involvement of the outsiders, an equal level of information between executives and outsiders, and the opportunity that they have a direct impact on the strategy. It is correct that the one-tier board needs to meet more often as many decisions for managing the business need board approval. Thus, the frequency of meetings might be around 5–7 meetings per year versus the usual four meetings of the two-tier board. The increased frequency, however, coincides with restricted time allocated to each meeting. Thus, the aggregate time spent is often comparable.

The executive member does not monitor, supervise, or correct themselves obviously. Thus, it seems that this aspect of the review of the performance is reduced in the one-tier system. This however can be compensated by establishing sub-committees chaired and staffed by the outside members.

More important is the question of whether the outside members really should or could have a direct influence on the strategy. In comparison: In the two-tier system, it is clearly the task of the management to propose a strategy. It is the task of the outsiders to advise, but it remains the decision of the management to which extent they incorporate any advice into their plans.

Several arguments can be raised against a direct impact of outside directors on the management. First, the outsiders have just a part-time involvement. Only the executives live and die with their tasks. Second, and this is perhaps decisive, the success of any strategy depends on the implementation. Only the executives can assume the responsibility for the implementation. They have the power versus the organization to motivate and secure the implementation, they also have the experience regarding the capabilities and the capacities of this organization.

4 Atmosphere

Beyond the formal design parameters of a board, there is the element of the atmosphere or the style of working in an organizational institution.

When in a two-tier board, the majority shareholder is the CEO who reports, for example, to a non-family chairman, then the element of monitoring, reviewing will also be moderated. The style will be more equivalent to the dialog among colleagues. On the other side: If a non-family CEO is an executive board member and a shareholder is a chairman in a one-tier system, then the actual reporting relationship might be equivalent to that of a two-tier board. Thus, our conclusion could be formulated as follows: The formal constitution and structure of the board is less important than the process. The processes are to a large extent flexible. They are primarily shaped by the intentions of the chairman and the attitudes of everyone participating.

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Design Parameters of a Board for Family Enterprises

Hermut Kormann

1 Variety of Basic Designs

We have emphasized that the topics and processes of the governance work are decisive for the beneficial effects of governance. The processes take place within a certain structure which is specific for almost each and every family enterprise. The structure is deliberately designed, is defined in the by-laws, and cannot be changed easily. Thus, we have to see the processes within the context of a certain structure. Therefore the "how" and "why" of defining the structure is of the essence. Let us try to give an answer in the form of an annotated checklist.

There is a broad variety of boards:

- Only family members in the board.
- Only non-business professionals in the board: lawyers, artists, scientists.
- Large boards of 12 members.
- A board of one person.

The fact that one example can be found for almost any design does not prove that anything goes. We discuss only principles that have a good probability of being effective and which have been tested in a multitude of cases.

Our reflection is based on the experience in Germany—as a member of a board or as a consultant to families on the design of their boards. Germany is a practical base for comparisons as both China and Germany have a two-tier system. This by the way would be the first design step: One-tier or two-tier (or we say often: two-chamber system). A one-tier system means that the board is formed out of members of the top management, such as CEO, CFO, and one or two other directors, as well as

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non-active directors from outside the company. In the two-tier system, the board consists of non-active board members only. The top management team reports in its entirety to the board. In reality, the ways and means of acting in the board processes can be quite similar in both systems. Anyway, the two-tier-system is clear in its allocations of tasks and initiatives. The management has the responsibility to develop initiatives for developing the enterprise and for augmenting its value ("Value creation"). The board has the task of monitoring, reviewing, and approving ("Value protection").

Then, of course, is the second basic assumption that we want to design an effective board—and not a "Rubber Stamp Board" only. An effective board has intensive communication with the management. The board members are qualified to the extent that the management can discuss with them on an even level.

The third general design element is the place of a shareholder as the CEO position or as the chairperson of the board. In our environment, the general recommendation given by advisors is to avoid that a family member as CEO has to report to a family member as chairperson. Family CEO reporting to Non-Family chairperson is good for the harmony and Non-Family CEO reporting to a Family chairperson is fine. But one has to add, often families do not follow this advice. Then a son or daughter as CEO reports to father as chairperson.

2 A Checklist

After clarification of these basic assumptions, the following are the items of our checklist on the overall composition and size of the board:

- Categories of members:
  - Non-active Shareholder(s) (see comment 1).
  - Independent, non-active directors.
- Total board size should be between three and a maximum of seven members (see comment 2) and should slightly outnumber the active directors of the management, e.g.:
  Two Management, Three Board
  Three Management, 4–5 Board
  Three Management, 5–7 Board.
- The Independents should have at least as many seats as the non-active shareholders (see comment 2), e.g.:
  Two non-active Shareholders and two or three non-active Independents.
- One of the Independents should be a professional expert in Accounting, Auditing, Controlling.
- One of the Independents should have insight into the type of industry (see comment 3).
- One of the Independents should have a broad network in business or politics (see comment 4).

Let us add some comments:

(1) Shareholder
Typically there is already the lone founder (or a key shareholder) in the executive team. In addition, there should be a non-active shareholder in the board. Think of the emergency situation in which the executive shareholder terminates his or her active role (in the event of illness or death for example).
There must be another active or potential shareholder familiar with the situation and the persons. In case of doubt, the spouse of the founder is a legitimate candidate for such a position. (There are many companies for which the spouses of the late founder have managed the company and the transition process to the next generation.)
(2) Often the pure theory requires a majority of the non-family independents, in order to secure the majority of Independents in case of conflicts among family members. In reality, these majority–minority aspects are of no relevance. If the family members respect the expertise of the independents, they will follow this advice no matter if they have the majority or not. However, the non-family independents should also not be a small minority versus the shareholder board members. This is essential in order to avoid a climate of "all is a family affair" versus a professional committee.
(3) The "Industry Expert" should not be active in exactly the same type of industry. First, such a personality has either close connections to customers or competitors. One would not expose the confidential aspects of the company's own strategy to these networks. Second, there is always a latent rivalry between experts in the same domain of competence, here between a too close Industry Expert and the CEO.
(4) Providing know-how and business contacts to the social, political, and economic environment is a legitimate function of a board. In summary, this checklist demonstrates that there is no indefinite variance of reasonable structures. The problem is less one of a board's structure than of attracting qualified individuals.

After having clarified the basic size and composition, one can move on to specify further details:

- Mode of electing family and non-family board members.
  - A simple majority of shareholders or relative election of those with the highest number of votes (in order to secure the representation of a person elected by minority shareholders too).
- Standard tenure: The longer the tenure, the higher is the independence of the board member.
- Maximum duration of the appointment.
  - Not only an age limit for re-election is relevant. Regardless of age limit, a maximum duration should be established, e.g., 10 or 12 years. One should think of a young board member elected at an age of 35.

- Number of regular meetings. Frequent meetings provide an inducement for the board to get too intensively involved in operative issues.
- There is a trade-off between the frequency and length of the meetings. The length of the (full day) meetings is more important than frequency.
- Limits of authority of the executive team or approval competencies retained by the board.
- Interface between shareholder assembly and board.
- Interface between external auditor and board.

These are the major points—some more could be added—which shape the *structure* of the board's work. To bring this structure to life, the qualification of the persons assigned is essential. How these individuals interpret their role, how they act, which goals they pursue will shape the *processes*. These processes, eventually, will generate the outcome, the value creation, of the board work. Establishing a valuable board is an evolutionary process. An experienced chairman is the most important catalyst for such an evolution.

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Governance for the Lone Founder

Hermut Kormann and Birgit Suberg

1 The Relevance

Governance is typically associated with larger organizations. Our question here is whether governance is needed also for the lone founder in the first generation. One can counter this proposal with arguments such as: "the scope of activities is too small" and "as the founder owns all the shares, he or she will be autonomous in their decision-making, anyway." The risk is to establish a rubber-stamp board only whose task is merely to wave through the proposals of the CEO.

2 The Need

Governance serves to safeguard the quality of leadership. Modern theory emphasizes the potential deficiencies in the leadership in large, public enterprises by an agent who follows his or her own interests. Clearly, these risks are irrelevant when the owner serves as the CEO. However, this is just one risk. As a matter of fact, the first generation is the phase with the highest risk of all. There is the "Liability of Smallness": The small business entity can be shaken by shocks in the market or in the financial situation. There is the "Liability of Newness": The acting managers simply do not yet have sufficient experience in coping with the manifold challenges. But even the very successful owner and manager faces a very peculiar risk—directly linked to the experience of being highly successful: Overconfidence and hubris. Ownership might give the orientation for developing the business but it does not by

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itself provide the competence to reach the targets. For all these reasons the failure rate during the first generation is very high. Reaching the second or third generation improves the sustainability significantly.

Important means of reducing the risk exposure and increasing the sustainability are—in most cases—not yet available for the first generation such as: financial reserves in the company or even some wealth outside the company or diversification of the business activities. Therefore, deploying the instruments of governance is even more important to the securing of sustainability in this dangerous first generation.

3 The Implementation

Good governance begins with the composition of the executive team. The typical founder is a business person, the executive for markets and operations. He or she then needs a counterpart for controlling and financial management—normally comprising the Administration, too. This person should provide complementary know-how. The responsible person should also act as a countervailing influence in analyzing the risks and opportunities of the business. It is in the best interest of the owner to have a person with autonomous judgment and the courage to defend this judgment in a discussion with opposing views.

This top management team should then report to an "institution." In the early phase of the development, this institution is—most likely—not a board with quite a few members. In this phase, we either find one person only to report to, or a small group of three individuals. Let us begin with the "minimum" design of a reporting relationship. "Reporting" might not be the best expression: "Shared reflection" might be a more illustrative term. There are basically two role models in professional activities which could provide a helpful analogy: The Coach and the Supervisor.

The Coach is a counterpart who takes care of the psychological, physical, and functional well-being of his or her client. There is a role of a Coach more oriented toward the psychological constitution of the client. But there is also a practice "Management Coaching" which focuses on the managerial performance. This is then, of course, an ongoing relationship.

The other role is that of a "Supervisor." Supervision is an established professional activity in the practice of psychotherapists. We see that in a wider context. Each profession has—most likely—an institution that can review the performance of its members in a specific case. For a long time (more than a century) companies have had to or may voluntarily engage Public Certified Auditors. Owners are well-advised to have their Statement of Accounts not only audited to verify the correctness of these statements or—as required today—to confirm that they give a "fair and true" view of the situation. Owners should ask the responsible partner in the Audit Firm to give his or her view from a "Supervision" perspective. This is an addition to the routine auditing work. An experienced partner in a qualified Audit Firm can cover an important range of evaluations of the business activity.

As the start-up grows to the size of an enterprise, this initial structure of a sole person develops into a board with several positions. In order to deploy the benefits of a board, an intense and trusting communication among all participants is required. A small group provides advantageous conditions for communicating.

In order to deploy the benefits of a board, a group of three non-executive board members seems appropriate. In a one-tier board system, this group would be complemented by the CEO and CFO as executive board members. In such a comparatively small group an intensive net of communication can develop.

4 The Role of the Chairman

Who should act as chairperson in such a board? The first question is whether a chairperson is needed at all? This question is definitely to be answered with "yes." The sole owner is a powerful person anyway and governance is therefore a delicate process. There is the risk that the board develops into a kind of talking shop, exchanging interesting points of view but without conclusions, decisions, and action programs. To prevent such a derailment, a chairperson is necessary with the responsibility to facilitate an efficient process. Process responsibility is the keyword: the responsibility for the content of decision-making rests with the entire group. Often the managing owner is reluctant to assume the chair position even in a one-tier system. From a governance perspective, it is better, anyway, to separate the chair and the CEO function. Thus, the natural design is to assign a non-executive board member to the chair.

These design criteria may be different according to the specific persons involved. In addition, criteria might be adjusted fairly frequently over time. The important thing is to get started at all. Introducing governance in the first generation is an important prerequisite for the successful transfer to the next generation.

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Agenda Setting: Clarifying the Strategic Situation and the Challenges

Hermut Kormann and Birgit Suberg

1 The Relevance

The decisive instrument for steering the advisory board meeting is the agenda with its agenda items.

In a weakly developed system, it can happen that no meaningful agenda is drawn up at all. Or one leaves it to the management alone to put specific topics on the agenda. A good procedure is that the chairman of the board collects suggestions for the agenda from the management, the board, the shareholders, and all legitimate participants (e.g., auditors) and then determines as the chairman of the meeting which agenda items are to be dealt with in which priority and within which time frame. This determination of the topics is a powerful management tool. Implicit questions are posed solely by the topic keywords. And every question in the room must at some point be brought to an answer—"he who asks, leads."

2 Timeframe

The agenda must specify a time grid. Each participant must be able to see in advance whether a keyword is just a short briefing or an in-depth presentation with the need for more intensive discussion.

If, however, a topic is so important that it is even on the agenda of a board meeting, then sufficient time must be devoted to this topic. This aspect is crucial and should lead to less important topics not being placed on the agenda at all. The time

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needed for the discussion is, by the way, chronically underestimated. If the discussion makes it necessary, it must also be possible to exceed the planned time frame. It is more important that a matter in need of discussion is finally clarified than that the timetable is adhered to. That is why we need time reserves in every agenda and topics that can, if necessary, be deleted, greatly shortened, or postponed.

3 Categories of Agenda Items

It is useful to distinguish some large categories of agenda items. This structure can be used to provide suggestions for filling in the content and it gives a grid with which priorities the individual items are to be dealt with. This can be clearly explained using the concrete example of an agenda. A standard agenda for four meetings per year is outlined below:

Standard agenda

1. Regulations:
   - Quorum.
   - Approval of the minutes.
   - Agenda (approval or amendment).
2. "Events since the last meeting" is recommended as an introduction to the meeting.
3. Brief reports on the economic situation:
   - Financial report.
   - Market, technology, and competition.
   - Technology report.
   - Summary of the to-dos and the most important three accomplishments for the next 3 months.
4. Annual program:
   - First meeting: First financials for the year.
   - Second meeting: Financial statements, auditor's report.
   - Third session: Strategy, long-term planning.
   - Fourth session: Budget.
5. Standard decisions (second session):
   - Annual financial statement.
   - Profit-payout proposal.
   - Approving the actions of the management.
   - Bonus.
   - If required: Proposals requiring approval.
6. Personnel and organization.
7. Special topics (as required).
8. Strategy and corporate development (spread over four separate meetings):
   - Analysis of business segments.
   - Market analysis (market shares, customers).
   - Strategic projects.
   - Analysis of countries.

9. Functional topics (spread over four separate meetings):
   - Quality report.
   - Development report.
   - Production report.
   - Financing.
   - Human resources development.
   - Risk report.
10. Preview of the next session's topics.
11. Top three tasks of the management for the next 3 months.
12. Next meetings.
13. Miscellaneous.

Most of the agenda points are self-explanatory. Here are just a few comments on some particular points.

4 Overview of Events Since the Last Session

The board and management meet only at longer intervals. The normal human reaction to this situation is to talk about what has happened since the last joint meeting, what is important for the respective company. The common concern, the "interesting," is the criteria for the selection of the reporting and not the relevance of the presentation for the supervision or the current or future need for the approval of the topic. For reporting purposes, the following classification options may be considered:

- Events over the timeline—a completely natural sequence that avoids the problem of selection and meaningful linking of events.
- Standard categories of consideration such as market situation, relationship with customers (e.g., notable orders won or lost), personnel matters, technical developments, and similar general categories.
- Topics of the agenda of the management: What did the management deal with in its meetings?
- Positive and negative/critical events Nicola Leibinger-Kammüller calls this category "Highlights" and "Lowlights."
- Logbook of events.

Such a—rather informal—narrative allows the participants to touch upon interesting aspects of the company and the owner family.

5 General Review of All Important Topics: Not Only the Urgent Ones

This agenda should include all categories which are important in this industry and for this company. It is insufficient to deal only with the topics which, for one reason or another, currently have priority. The strategy is built upon the deployment of the strengths of the company. One has to review the status of the strengths on a regular basis.

6 Emphasizing the Urgent Needs Too

While this regular review of all important items is somehow far-sighted, this wide view has to be balanced by a spotlight on the tasks to be addressed immediately: The top to-dos for the next 3 months.

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Monitoring: We Need Meaningful Data

Hermut Kormann and Birgit Suberg

1 The Relevance

Governance means monitoring as well as advising. In both tasks, one needs to understand the situation and the challenges. The non-executive board members can and even should not be directly involved in the activities of the organization. And further, they meet only on a quarterly or bi-monthly basis. Thus, all the judgment they can provide is based on indirect information that is prepared for the board meetings. Indirect means that the data and their evaluation is provided by a reporting executive. He or she is the mediator between the "reality" and the picture of the reality which can be seen and interpreted by the board.

The quality of this indirect information decides ultimately the quality of the board process. As so often in topics of leadership or strategy it might be difficult to define exactly what is positively needed or correct. But one can fairly stringently describe what is not sufficient. Let us try to do that.

2 Too Much and Too Detailed Data Without Verbal Explanation

This is the most mundane and most frequent issue in small and medium-sized companies. The same set of reports as prepared for the management is submitted to the board—and without further explanation. It is positive—has even to be requested—that the board receives basically the same set of consolidated reports

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as the management reads. The difference is that perhaps the reports for the management are not consolidated to relevant grand totals and—more critically—that they come without proper verbal explanation. The reporting concept has been applied within the company for decades. So, all of the insiders know where to find which data and how to interpret it. Seemingly.

However, for the external board members who serve on various boards, this is an awkward situation. They are in the role of first-line clerks who have to analyze the data themselves in order to find rhyme and reason in them. The solution is: Data only as backup to verbal reports. There should be no page with raw data only without explanation of the story which the data is supposed to support.

3 Focus Primarily on Budget Comparisons

There are basically five dimensions of business data:

Past actuals
Current actuals
Budget
Forecast
Comparison to industry or competitors' data

The Budget is an instrument to document the commitment of the departments. Within the first 3 months of a business year, the variance between current actuals and budget cannot be properly interpreted: It could be a non-systematic variance which will level off in the subsequent months, it could be the result of an over-optimistic budget or—and this is the only relevant information for a board—it could be an indication on the changing trend—positively or negatively—of the current business development.

As soon as possible this change should be reflected in an updated forecast which is for the board the only relevant information. In order to see the trend, the easiest way is to calculate the actuals (sales, profits, etc.) as the 12-months-moving-average. After 2 or 3 months of an increasing or decreasing curve, one can clearly see the trend. But to stop and reverse a declining trend takes another 3–6 months. Therefore, it is vitally important to recognize the early signals in the trends.

Of course, the industry or competitor data are relevant, too. But they are typically only available with a certain time lag.

4 Unconsolidated Data

Even medium-sized companies are comprised of a number of separate legal entities. These entities are connected by intracompany sales. Profit however can be generated only by sales to external customers. Therefore, the development of the external sales is of the essence. Specifically, one has to avoid creating the false impression of

growth created by increasing intracompany sales. These intracompany sales increase the figures both for the sender and the receiver, seemingly indicating an upswing whereas the consolidated sales were stagnant.

5 Changing the Organization Structure or the Business Year or any Similar Basic Structure

Such changes are typically implemented on short notice. As they are announced as a major instrument to change the whole situation for the better, these changes are implemented without further delay. A side effect is that the changes eliminate any comparable data such as the previous year or even budget and previous forecasts.

6 Intransparent Accruals and Intra-Year Adjustments

The decisive month for the results of 1 year is in each and every company the last month of the business year. It does not matter if this is December or any other month. Sales are significantly higher in this last month as accrued deliveries are finally invoiced. Further, up to one-third of total earnings per year result from year-end-entries. These cover one-off expenses, expenses paid once a year only, accruals for future expenses, and so on. In order to get a fair picture of the intra-year development, the accountant in charge has to make appropriations, accruals adjustments. He or she is more or less the only one who can assess whether they have enough reserves or will have difficulties in meeting the forecast. This is why the forecast is so important. In the forecast, these experts have to put their cards on the table.

7 Insufficient Time Frames

Extant research identifies the rigidity of management in the face of changing requirements as a root-cause of decay. The first prerequisite to avoid this trap is to identify changing requirements early enough.

In the very short term, the moving-12-months-average in reporting is one of the easy instruments to identify changes in the trends. However, short-term trends are either clearly going up in boom-times or clearly going down in recessionary times. These clear trends can be easily explained. The short-term trends fluctuate around a long-term trend. The recognition of the long-term trend is essential in order to identify the need for adjustment in a structural manner.

Again, a very easy instrument is a 10-year-comparison. Ten years include a full business cycle—thus the cyclical fluctuations are leveled off. Ten years clearly demonstrate if the company is growing fast enough in line with the overall economy or industry. The comparison of the first and the last year in the timeline shows to which extend the structure of the expenses had changed.

8 Too Much Focus on Effects Only and Neglecting the Causes

Sales and profits are the effects. They cannot be influenced directly. There are many causes that lead to these effects. One has to identify the key performance factors which influence sales and profits and so on. Material quota is in any industry a key factor. Personnel expenses are key. Quality costs are key. It is more important to check the material quota regularly and the personnel expenses as a percentage of value added (sales minus material expenses) than the profit percentage. The former are causes, the latter is an effect.

9 Too Much Focus on the Average and Neglecting the Span of Deviations from Average

Any management report consolidates the thousands of pieces of data resulting from the individual business transactions in aggregated sums: Grand totals, subtotals, averages, percentages. This consolidation provides a necessary first step by getting an *overview* of what is happening. But in order to gain *insight* and understanding, one has to dissolve the grand totals again into the key cause factors. In order to achieve the dissolution of the aggregate data, one has to illustrate the span of variations. Specifically, it is important to identify variances by the outliers, the odds, the leaks in profitability, the losses. In this analysis the famous 80/20-rule is relevant. Such a breakdown of complex data discloses those 20% elements of the system which generate 80% of the result. Thereby it helps to single out the most important factors. Such an analysis reveals also the loss-generating segments. This analysis of the losses is key in order to understand the basis of profitability. This is further elaborated in the next paragraph.

10 Too Much Focus on Costs and Neglecting the Price Quality

Right from the beginning, teaching good Business Administration has emphasized the cost analysis more than the inquiry into the price structure. Profit and Loss Statements have one line for sales (volume multiplied by prices) and various lines for expenses. The internal statistics analyze each cost variance. It is rare that price variances are scrutinized in a similar degree of detail.

11 Not Drilling Down to the Details but Revealing the Essentials

Meaningful insights are not achieved by the details of “big data.” Meaning is revealed by the essentials in the big picture. Reporting to the board helps to show this big picture and to discuss its meaning.

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The Difficult Task of Advising

Hermut Kormann and Birgit Suberg

1 The Task of Advising

Each board has three main tasks: (a) The competence to select the executive team and to manage the contractual relationship with them; (b) Supervising the activities and monitoring the performance of the executives; and (c) Advising the executive team. Supervision is typically an evaluation in retrospect. It does not influence the supervised action anymore. Advising, however, is an influence that precedes the final decision process. It can be of specific value and is therefore of high importance.

In an advising communication, two or more persons exchange data, views, and evaluations. They search for a good, "advisable" route of action. Both "exchange" and "search" are essential.

2 The Advisory Role of a Board

The functions of a board comprise both supervision and advisory and some other functions, too. Advisory is understood as bilateral or multilateral communication in the search for good action programs.

Advice follows the supervision of the company's situation and the ensuing formulation of the agenda for the executive board and the supervisory board. Advisory does not always have to lead to completely new insights. It can also confirm a good action-proposal.

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Advice can only succeed if management and the governance body engage in an advisory discussion on a level playing field. In the advisory process, the supervisory board and management must discuss problems as "colleagues." This requirement distinguishes consulting from other activities. Supervision can and must be exercised, irrespective of whether the supervised person feels a need for this review of his or her actions. The same applies to control interventions, such as setting decision standards or granting or denying approvals. They depend only on whether the supervisory board deems it necessary and not on whether management has asked for them.

3 The Importance of Advice

Advice is equally as important as any other governance function. If one understands governance as a support to and assurance of the quality of corporate management, one will rate advice as the decisive contribution. This applies above all to strategic issues. And this advice is again specifically important in medium-sized and family-owned companies. The priority of the deliberations becomes quite clear when a managing shareholder reports to a board as the governance body. There is hardly any agency problem here, which stands in the foreground. The function of the board is to ensure, in the interests of all shareholders, including the minority shareholders, that the corporate management is "good."

Strategic questions for the development of a company are always important decisions with long-term consequences. These are one-time decisions in which there is no routine, and decisions with high uncertainties. Medium-sized companies in particular are constantly confronted with development paths that they are encountering for the first time. In such a situation, the advice from decision-makers who have repeatedly had to work through similar problems is helpful. Family businesses have the great advantage that the shareholders are, for good reason, intensively involved in the development of their company. However, this focus lacks the breadth of experience in other companies and sectors of the economy. External members in a board can contribute to the quality assurance of leadership by contributing their different and possibly wider experience. Above all, they can focus the unbiased view of a third party who has not been involved in the management's opinion-forming to date and assess its viability.

4 Advising Implies Searching for Solutions

An advisory role presupposes a need for advice on the one side and a competence and a willingness to give advice on the part of the advisor.

If the CEO is absolutely sure what to do, presents the complete action program, and defends it only, then there is hardly any room for advising. This shared exchange of views is only needed or even possible if the CEO is not yet fully committed to the

proposed action if he or she desires a double-check of the proposal and seeks confirmation.

If a group of advisors already know "everything" and above all "everything better" than the other members, then the consultation is not successful. If a participant is "biased" because he or she has already formed a firm opinion, he or she will not be receptive to advise. Even if the prerequisites are fully met, one must be aware of the limitations of consulting in a governance body. This advising is fundamentally different from management consulting, but also from systemic consulting. These latter advisors usually accompany the management or a management team through all phases of the planning and decision-making process: from the creation and preparation of the input for the decision-making process (data, options, decision criteria) to the processing of this input in the planning work and the formulation of decision results. Participation in the entire planning and decision-making process requires a considerable, continuous deployment of personnel and time.

A governance body, on the other hand, meets only at greater intervals and only for one-day meetings. Its consulting work must, therefore, be concentrated on specific segments of this process. These are the specifications for the desired output of the decision-making process and the input required for this. The demand for output may be expressed in terms such as: "We need a growth plan," "We need a comprehensive innovation initiative," or "We need to decide whether we should seek acquisition opportunities." In order to specify the input, the management must first of all work out the requirements for the information bases. However, the most important contribution in the consultation intercourse is usually the argumentation about which decision criteria should be the decisive ones for options. Is it all about the expected "success"—however it is measured? What are the risks if expectations are not met? How much can the occurrence of the maximum risk constellation impair the company's development potential? What are the requirements for ensuring financial equilibrium? Is there a plan B? What conditions must be created for the implementation of the plan?

5 Some Prerequisites for Successful Advising

5.1 Curiosity

For the advice process in a governance body, the management usually has to contribute to the essential amount of information—often in the form of a presentation on the topic. This presentation will only lead to a fruitful discussion if the management is curious to hear what contributions the other members of the committee can make. This curiosity is evidently lacking if the management gives an immediate answer to every contribution by the external mandate holders in the form of: "This is not true because . . .", "This may be true in other companies, but it is not transferable to our company . . .," or "We have already thought of this." A curiosity for a conversation is shown by the fact that there are open questions. If the management already submits a proposal for a complete action program, then only the

approval, rejection or conditional approval of this remains. These are the modes of supervision. If the management is looking for advice, then the conversation should start at a time when the opinion-forming process has not yet been completed.

5.2 Competence

Being curious for additional decision input is thus the precondition for a fruitful advisory process. However, a counseling discussion is only useful if the participating experts have something to say. This presupposes competence. They need to be respected for what they contribute. With respect to the competence, it is often asked if an eternal board member should have the expert experience in the specific line of business of the enterprise. We do not deem that necessary or even possible. The CEO of our competitor might have the best alternative industry expertise. But obviously, I do not want him or her on my board. The best industry expertise should be provided by the management. It could even be detrimental if internal and external board members compete in demonstrating who has the best expertise in the details of the business. Of course, some of the board members should be familiar with industries that have similar characteristics to the enterprise at hand. For example: retail or machine-building or fast-moving consumer goods. Within these broad frames, the competence of outside board members should be general, wide-ranging, and based on a longer time span. The competence of the advisors must excel in the task of managing complex situations, the ability to assess uncertainties and to deal with them, the capability to set priorities for conflicting objectives, and much more. As they have already previously experienced a similar decision dilemma, they can help to weigh up the priorities. As they have gone through more recessionary cycles, they can help to develop an appropriate "sense of urgency."

It is also a remarkable statement if the management's proposal is considered to be good, especially if the reasons for this judgment are explained.

5.3 Independence Without Prejudice

The advice is respected if the advisor is trusted to act in the best interest of the advised person. Therefore, an autonomous and financially independent personality is better entitled to be trusted.

5.4 Competence in Communication

Advising requires a dialog among parties of equal standing and the shared search for a good proposal. The participants have to refrain from referring to their power status. It is poison for an advisory dialog if a shareholder refers to the ownership as an

argument. Ownership gives the authority for instructions but not the wisdom for advice.

This problematic situation can be created by shareholders who misunderstand their mandate to the effect that they deploy the board as a platform for the representation of their selfish interests.

An open-mindedness also presupposes that the chairman of the board and the management have not yet “fixed” their position in advance. It is good practice when rendering advice or making a judgment that the highest-ranking member of the group keeps the course of the deliberations “open” and contributes his or her own opinion only later perhaps even just in summarizing the discussion at the end. However, this is only credible if the decision has not been clarified beforehand in the small circle of the presidential committee of the board. On the other side, consulting in the context of governance has to be more than just an offer of knowledge that leaves it up to the recipient to decide what to do with it. This may be sufficient for a board, which a managing sole shareholder considers to be a discussion group, but which has no governance function at all. Advising as an element of governance pays off by the fact that a good program of action is found. If the management’s proposal for action is not good enough, a better proposal must be drawn up. This requires an argumentation with a certain claim to validity. So, it is also a matter of mutual influence, but with very discreet, indirect interventions. A very direct, strict advice could be interpreted as a camouflaged instruction. In order to avoid this, a certain amount of experience and communicative competence is required. Colleagues must be communicatively competent; otherwise, there is no fruitful cooperation between team members with equal rights. As chairman of the board, some managing partners who have been accustomed to giving instructions for decades find it difficult to develop this dialog competence. Even as inactive shareholders, such former power holders still believe that they can determine what has to be done by “their” elected representatives—provided they find someone who takes on such a modest role.

5.5 Time for Reflection

In order for an advisory dialog to develop with given professional competence and communicative competence, there is a further, essential, component needed: time. In almost all committees, the time for the discussion topics is endangered by the fact that the reports on current business activities are placed at the top of the agenda and consume too much of the available time. This time is then inevitably lacking for the subjects of consultation, which only appear later on in the agenda.

The second reason for the inadequate advising time is that the topic is only called up once. The executive board has certainly prepared a draft for complex topics in several meetings; this will be presented and now the board members are to make their comments. It would be appropriate for the panel to be able to reflect on the issue and for it to be given regular consideration. Experienced chairpersons of boards can thus control the way the issues are dealt with.

In fact, consulting is the part of governance that places greater demands on external members, but also requires the first-hand experience of management in the joint discussion. And this difficult part will only succeed if the chairperson of the committee has the moderating competence and ensures that advice supports rather than impedes good management. Improving the steering of the enterprise is what governance is all about.

6 From Deliberation to Resolution

The advisory process is concluded with the forming of an opinion. If the initiative for a project originates from the members of the board and if the initiative is not fully supported by the management, then this initiative must be abandoned. The process of implementing the initiative is, after all, entirely the responsibility of management, and it must ultimately assess whether an initiative can be implemented. (This also corresponds to the abstinence of the supervisory board of a stock company in questions concerning the day-to-day running of the business—as this is stipulated by the German law.)

If, in an initiative, irrespective of who submits it, the board of management and the supervisory board are of a common opinion, then they will decide on it accordingly. However, if—in the opposite extreme—there is no predominant opinion at all, then it usually remains with the previous decision, the status quo. If it is a matter of opinion-forming on management initiatives and the board itself is ambivalent in this respect, but the management board is unanimously behind its proposals, the chairman of the board will plead for approval of the management's proposal—unless this proposal is too risky. This preference for the opinion of the management arises from the consideration that in case of doubt, the management has the better knowledge and must bear the consequences of the decision directly. However, if the members of the supervisory board are overwhelmingly of the opinion that the management's proposal for a decision is not "good," the management will withdraw its proposal in its own interest. There is too great a risk that, in the event of a failure, the management's lack of insight will have a negative impact on the evaluation of its performance.

In any case, the deliberations must be concluded by a clearly separated act of resolution. With this decision, the consultation will move into the next phase of governance, the steering. Every decision—especially after a thorough discussion—has two effects: the decision on an individual case and a precedent for future, similar decisions. This precedent can be underlined by the fact that a general norm for the company's strategy is formulated on the basis of the advisory process. The collegial, organizational learning process of the counseling discussion is thus anchored in the strategic know-how of the company.

While everybody's input is equally valid in the deliberations, the final decision has to be taken by the authorized responsible body. And that decision must be followed by everyone. This is a fundamental principle of collegial and loyal cooperation. If the supervisory board opens up in the mode of consultation and collegial

cooperation with the management, it is also absolutely entitled to hold management to the final decisions.

7 Consulting as an Integral Part Between Supervision and Control

In the development of theoretical concepts on governance, there have been discussions on whether the consultative role of the board does not impair the independence of this body. The point of view here would be that the most important role of the committee is to judge the performance of the management. However, this discussion has long since been concluded, with the acceptance that consultation is a necessary part of the governance work. It is certainly beneficial for fair supervision if the supervisors themselves have experienced the difficulty of decision-making.

These suggestions for an advisory communication might seem idealistic. Still, it is essential to emphasize that advisory is different to the scrutiny required in supervision. And it is worthwhile pursuing the ideal, as only good advisory leads to an added value in the form of better decision-making.

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To Create a Sense of Urgency

Hermut Kormann and Birgit Suberg

1 The Relevance

In the overall context of governance, it is the responsibility of the full-time executive team to come up with ideas of what to do. The executives assume the responsibility for analyzing all factors which are relevant to the assessment of advantages and risks. Now, what can the contribution of the external members of a board be? This question refers to the chairperson, too, if he or she is external or no longer fully engaged in the business operations.

Their function cannot be to have *better original ideas* than the executives. Their task can only be to start from the set of proposals the executives come up with. Their role is to evaluate these ideas. They do that by serving as independent *discussion partners*. For an executive, the creator of an action proposal, it is somehow difficult to discuss with oneself. It is easier and more fruitful to discuss with another person who is respected and interested in their affairs. Often these outsiders can contribute to the action proposal by their *outside experience in other businesses*. These outsiders have their own *network* of business contacts which perhaps can be instrumental in the execution of these ideas. Perhaps most important is the fact that the outside board members are typically seasoned executives. In *more service years* they have accumulated more challenges, more successes, and more failures than a younger person with less service years.

This extended experience base as an executive can give one advantage: It increases the chance to set the right priorities. Let us elaborate on the importance of setting priorities in action programs. In management typically the challenges are

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known—at least to a large part. Technology is progressing, competition is increasing, customers are more demanding, costs are rising and so on. Also, the recommendable activities are included in each and every training program in strategic management: Analyze the situation, identify options, set direction according to overriding targets, implement, control, and feedback lessons learned. Then are, of course, numerous toolboxes available to perform these general phases in each specific action field. The awareness of all major challenges and the oversight over hundreds of recommendations for appropriate tools leads to planning overload. This overload paradoxically does not lead to a speed-race in the execution of the projects. Quite to the contrary.

2 The Problem

Again and again, we have listened to presentations on future strategy where dozens of actions are listed, often with a demanding investment program to expand the promised benefits of the new strategy. Somehow, we are trained to design the big thing before we improve the small thing. For example, I recall an investment program to open up ten new outlets for a retail chain. Then the board requested a parallel program to "make good" marginal existing outlets. This improvement of existing outlets turned out to be more relevant for expanding the market share and improving the profitability than increasing the market coverage by new outlets. (Of course, the expansion was reasonable too, but the refurbishing deserved the clear priority).

We are working and working on too many things. By doing that, we overshadow, through sheer volume, the importance of the really important projects. These really decisive issues are slowed down. They are also slowed down because the really essential tasks are difficult and we hope to find better solutions if we work longer on these tasks (which, incidentally, is not in itself wrong).

3 Tools for Setting Priorities

Governance can be a remedy to at least curb such a dangerous development. Alone the routine reporting on the status of affairs requires the structuring of events and the allocation of importance. Setting the agenda for the executive team—and for the board, of course, too—is an instrument to organize priority setting. This agenda-setting requires discussions. One of the most important contributions the outside members of the board have to make in such discussions is "creating a sense of urgency" in coping with issues of which the relevance is underrated. There can be a marginal business segment that has been marginal already for a long time. There can be a legal dispute which seems to be successfully handled by the lawyers. There is a complaint by some customers which our staff departments judge to be without justification. There are reports from the surveillance of patent applications that one

competitor is filing patents for a new technology which our experts rate as not very promising.

In these discussions, the outside board members bring to bear their additional experience and the oversight from their distance as outsiders in order to create a sense of urgency for the urgent tasks. Now, what is required to develop this sense of urgency? There are two kinds of urgency: One results from the importance of the matter, the other one results from the need for immediate action or at least action as soon as possible. There are some generic tools to find out and communicate the respective urgency.

We truly believe that in any business model—as in any system—the rule applies: 20% of the elements of the system influence 80% of the outcome of the system (Pareto-Rule). It is incorporated in the doctrine of “Key Success Factors” and, indeed, the basis of any military strategy. This is the urgency due to the importance of the subject. It is an elaborate analytical process to identify those factors. Who are key customers: Those with high volume, those with whom we have a long-standing relationship, those willing to dare new technologies with us. Price is in most markets a key success factor. What increases price quality? According to plausible empirical research (Buzzel/Gale), quality and service are key factors relevant to price. Those cost elements which form a high portion of total cost and which can be influenced by managerial activities are key. Key Success Factors require urgent attention.

An effective inquiry to assess the importance is to analyze the consequences if our assumptions and action programs are wrong. What if…? If the consequences are disastrous, then it is a key.

In assessing the importance of an action element, one should find out the root causes of effects. The profitability of a business is an effect and it is an average effect. Nobody can influence an effect and nobody can influence an average effect anyway. One can only influence cause which leads to an effect: Volumes of sales, sales prices, quantities of resources used for an effect to name a few. And one cannot influence an average such as the total profits on sales. This is the effect of a multitude of input factors. Therefore, it is always useful to break up an average of anything into four quartiles of best, average positive, average negative, and worst. Thus, take the total sales of your company and group that into four quartiles of diminishing profitability. It is always a surprise that behind the average there are very positive, but also fairly negative quartiles. Of course, working on the worst quartile gives significant improvements.

Now there is another category of urgencies in terms of timeliness of action. In these cases, one does not achieve any good unless one acts early enough. How to develop a sensitivity for the urgency in timing?

For some decisions, there is a window of opportunity. Speaking from experience, we say: whenever one meets an advantageous, lucky situation, deploy it as soon as possible. The window might close again. The need for timely action is even more stringent in the face of negative developments. One can think of the analogy of firefighting: The fire burning right now originated half an hour ago from a small fire and will be more damaging in another half hour. Thus, immediate action is needed to stop further expansion of the negative development.

Another technique to develop the feeling for the essence of timing is to "retropolate." Start from the date at which an effect is needed and then plan backward to the starting point for preparing and implementing the effect. Between start and full effect, there is an elapsed time. Calculate this elapsed time conservatively. And then do not concentrate on the quick wins of actions with short elapsed time primarily. Concentrate on the items with big effects and long lead time as the first things to be done.

Again and again, it is important to show the trend in the development of the performance data. For any variance in the short term—e.g., financial results to the previous year—there are current influences in this short period which give some explanation of this specific variance. Then ask for a curve showing the development over the past 5 or (in a German mature company) even 10 years. Then one sees immediately the trend. Alternatively, do not analyze the variance of actual order entry to budget, but show the trend in the last 12 months (12-month moving average). Here you can see the inclination of the curve, the trend. A change in the upwards trend to a downwards trend is identified at least 2 or 3 months earlier than by other methods of variance-analysis.

4 Good Times as Warning Signal

Finally, a somewhat paradox signal is given when everything is in an ideal status and no change seems desirable: Order entry is up, profits are up, interests are down, credits are available, competitors are fully loaded themselves and not hungry. One should really celebrate such a positive development and give praise to the efforts of the management. However, be aware: Such an advantageous situation has not ever in history prevailed for a longer period of time. Therefore, it is safe to assume that it will not continue forever. One had better get prepared for a change in the overall economic climate. One has to develop new products when the existing ones have peak sales, one has to refurbish the assets as long as they are still in good shape and so on. If there is no challenge, you have to create your own challenge by developing a sense of urgency for staying alert.

We consider it an important role of the board to develop a sense of urgency and communicate this impression to the management. This communication requires that the ramifications are clarified in open discussions and that the identified issues are kept in the limelight of monitoring. Underlining this function of the board we would warn at the same time against being too specific in describing what needs to be done. Addressing an issue and emphasizing the urgency is enough for a board to do. The board is posing the challenge to the management. Deciding how to cope with the challenge is the competence and the responsibility of the management. The management has to deploy whatever capacity and energy are needed to solve the problem. If a board member can give some specific pieces of advice—fine, but it cannot be the task of the board to specify the complete action program for solving the challenge. This is because any strategy has only that value which is demonstrated by the

implemented effect. Implementation is the key—and this depends on the skills and devotion of the management fully.

Then, after the action, comes the monitoring: is the "fire" completely extinguished or is a regular checking advisable? And, this is an important role of the board again, the successes are to be celebrated. In difficult times it is important to celebrate the progress made in order to keep up the motivation and the momentum of action.

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The Board's Key Role During a Crisis: Such as COVID-19

Joseph H. Astrachan, Andrew Keyt, Hermut Kormann, and Claudia Binz Astrachan

1 The Challenge

A board's oversight and guidance, based on the expertise, experience, and personal qualities of its members, have always helped drive business success and survival. But now, as the COVID-19 pandemic shakes societies and economies around the globe, boards play an even more critical role. Companies that can tap their boards' crisis mitigation skills will likely have an edge over companies whose owners do not recognize the board's potential or cannot encourage board members to step up.

For family businesses with many shareholders, the board's role is especially critical. The board can help build and preserve family commitment and continuity when tough decisions must be made. It can be a trusted expert about future prospects and difficult but necessary changes, and a respected arbiter of the many tradeoffs between family benefits and business survival and prosperity. The calming influence of the board can steer the family away from destructive behaviors that undermine the family and the business: emotional outbursts, inappropriate attempts to influence others, and more. Lastly, their impact can be long-lived if they serve as mentors to family business leaders and employees, and help them reflect on how they have handled and learned from difficult times.

The current pandemic is unprecedented in its impact. Companies must simultaneously think outside the box, develop a variety of plans that adequately respond to different scenarios, and use what they have effectively. This chapter describes the

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board's responsibilities in this current environment and proposes some ways that family businesses can leverage their board to help both the family and the business during a crisis.

2 First Things First: Setting the Frame

An important first step, and one that requires the voice of all board members, is to define the assumptions under which people in the organization should plan and execute the measures proposed. These basic assumptions help family members understand what the business must do and the expected outcome, and will affect family commitment and cohesion.

2.1 Duration and Extent

- The board agrees on their assessment (ideally based on reliable data and expert opinions) of how long the crisis will last (e.g., 6, 12, or 18 months)?
- The board agrees on their assessment of the assumed shape of the curve (again, ideally based on reliable predictions) of the impact. This means plotting out when the crisis will peak, whether it will peak once or more, how much time will be in between peaks, when recovery can be expected, and how the company will prepare for all of it.
- The board acknowledges the reality of "delayed effect," which is a basic law of firefighting: The flames you see in this very moment are those that originated half an hour ago, and the fire an hour from now is exponentially worse.

2.2 Business Model

- The board evaluates whether a radical change in how business is done is needed in order to survive (e.g., changing the customer base from restaurants to individual customers or a channel that directly sells to households)?
- The board identifies any opportunities upon which the company can capitalize on the current environment, without violating their moral code (e.g., talent acquisition)?

2.3 Stakeholder Philosophy

- The board agrees on a philosophy regarding how the company treats its people (e.g., layoffs, salary cuts, furloughs, sick leave policies etc.).
- The board decides on how, and in alignment with key company/family values, central stakeholders like customers and suppliers shall be treated during this crisis

(e.g., extended return periods and generous receivables policies for customers, flexible payables policies, depending on the company's ability).

One thing that is often forgotten is that these basic assumptions have long-term consequences. If, for example, the employee or customer-related policies are inconsistent with the values and culture of the company (making you appear overly opportunistic), you will likely spark mistrust, effectively damaging your relationships with your stakeholders.

3 Ensuring Sufficient and Effective Processes

Once all the basic assumptions have been defined and agreed upon, the board needs to make sure that the processes inside the company are sufficient for dealing with the crisis.

1. Sharing Information and Best Practices: A multi-unit company should create crisis teams at both the corporate and unit levels to coordinate information and best practices.
2. Reputation Management: The board makes sure that a process is put in place for monitoring and responding to potential PR/reputational issues. For companies not large enough to hire someone to monitor the media, this task could be assigned to the leadership team. We know of one case where a worker tested positive for coronavirus, and the media caught wind; by the time the company could correct course, customers had already declined deliveries.
3. Health Policies: The board ensures that a group is developed and staffed dedicated to defining, executing, and monitoring policies around employee hygiene, working conditions, sending home high-risk employees, or limiting the number of people able to enter certain areas.
4. Monitoring and Adjusting to New Federal, State, and Local Laws and Regulations: It is somewhat unfortunate that even when a crisis sows fear and uncertainty, government entities are still changing regulations and laws without ample warning. The board needs to ensure the company has a process to stay aware of changes and respond quickly. Likewise, board members themselves need to be informed about the many regulatory and legal changes.

These are but a few areas that might need increased attention; others may arise. All need targeted action.

4 Monitoring and Driving Progress

Once a set of plans and measures has been defined to mitigate the crisis, the board has the responsibility to oversee whether adequate progress is being made as events unfold at a rapid pace. Weekly or bi-weekly board phone calls are strongly advised.

1. Measure progress, in particular, tracking whether specific plans have been developed, and then continuously monitor whether those plans are being implemented.
2. Encourage senior leadership and appreciate their loyalty and hard work.
3. Make sure activities are coordinated across the entire organization.
4. Receive and discuss reports on employee, customer and supplier issues, and other crisis-related risks.
5. Closely monitor financial performance, particularly cash flow, and take action as appropriate.
6. Debrief everyone on the measures taken, the results, and the progress made so they can learn from it.

The key here is to maintain a flexible mindset, to seek and absorb new information as the situation develops, and to continuously adjust the frame or other elements of the plan as new information unfolds.

5 Communication

During a crisis, your communication must be timely, transparent, and appropriate. If you think you are communicating too much, you are doing the right thing:

- Shareholders: The board has a key role in reassuring and communicating with shareholders, either directly or through the CEO.
- Stakeholders: The board can have an important role in reassuring and appreciating employees, either directly or through the CEO. The board should stay in close contact with the CEO to check on employees' emotional state (the primary worry here is about them being burnt out).
- Family: Some family members may not be shareholders, but still affect the attitudes and decisions of the ownership group. They may have questions. The board can alleviate fear and doubt, reassure them, and generally help the leadership engage with the larger ownership group.

Staying connected with your key shareholders and stakeholders, and having the appropriate emotional messaging, is key during this challenging time. The variety of technological platforms available today (text, call, Zoom/Skype, email) can be incredibly helpful in achieving these goals.

6 Worth Remembering

Before you put your board to work, remind them to consider the following caveats:

6.1 Check Your Biases

One mistake people often make during a crisis is setting their frame based on how they want to treat people. For example, because you may be reluctant to let people go, you might convince yourself that this is a short-term issue, when it very likely is not. The opposite also holds true. If you are more challenging and direct with people, you may be overly tough on others during a crisis, which could backfire.

6.2 Encourage Candor

Make sure that all board members feel confident actively challenging ideas. Without candor and full participation in setting the frame, the business will not make sound decisions or execute them well. For example, if one very vocal or overly emotional board member dominates the group, other board members may be afraid to speak the truth and they may all go along with a bad idea.

6.3 Consider a Full Stop

An axiom of crisis management is that it is like driving into an impermeable wall of fog, an unknown situation into which you have no visibility. The best course of action for assuring survival, and then growth, is to first come to a full stop and then slowly accelerate to an optimal speed for the situation. For business, this translates into taking the hardships early (laying off employees, cutting customers, and having difficult conversations with financing sources). Then you can manage how you accelerate to a proper organizational tempo and size (for example, hiring people back, expanding operations again, and adding interest-bearing debt to the balance sheet). Unfortunately, at times management mistakenly believes that slowing down gradually is the best thing to do. They start with small actions and then increase their intensity and frequency. But disaster can result if they apply the brakes too timidly or too late; they risk cash shortages, technical bankruptcy, and greater future hardships. Not making the tough decisions early also gives employees false hopes and keeps the people you will likely lay off from being able to find new employment in a timely manner.

6.4 Be Encouraging

Because boards tend to have reviewing and accountability functions, the first reaction is often to criticize suggestions brought forth by management. Instead, boards should encourage and approve any proactive initiative taken by management. In a crisis, the right timing of acting is more critical than choosing the ways and means. This is especially true when situations are rapidly changing and new actions

in all likelihood will happen quickly. And do not forget—the board's role is "nose in, hands out." Do not get too involved in the details.

Remaining calm under fire will help businesses make strong, well-informed, and rational decisions, and avoid being rash or emotionally driven. Companies can prevail over adversity if they effectively mobilize their resources (including their boards), if they are openminded enough to continuously challenge their decisions and actions, and if they have authentic, transparent and frequent communication with all their stakeholders.

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Part II

The Board’s Discussions on Topics of Family Enterprises’ Strategies

The Key Issues of the Family Enterprise's Strategy

Hermut Kormann

1 The Key Question

The starting point of any strategic thinking is the question. "What are the needs of my company?"—or even more focused: "Which is the need of utmost importance?" The result of the analysis is the "agenda," the action program for the next 2–3 years entailing the gross assessment of capital investments required. Specifying the needs is the most important phase of strategizing. Otherwise one runs the risk of working with a high concentration on secondary tasks. This would mean spoiling the most valuable resource: Management time! There are just four broad categories of needs in a company which have a clear ranking of their priorities. (1) Is the company and the owner group stable? Is our financial base stable? Are the shareholders loyal to the company or are we plagued by conflicts or facing an unsolved succession phase? (2) If the company is a fairly stable organization, then the next question is about the sustainability of the whole business line or industry or our specific business model. (3) Only if this stability can be assumed, can we address the normal strategic questions. Here again we have to ask first whether the company earns enough. (4) And if the earnings are sufficient the final question is to be explored: How much growth can we accomplish and where can we find the growth opportunities? In the following section, we reflect on those basic questions.

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2 Are We Up to Driving the Strategic Development of a Company Forward?

A strategy involves the long-term development bringing with it opportunities and challenges, for which funding, managers, and time are needed. If a company, however, finds itself in a crisis, then these resources are not available for strategic work. In the typological sequence of a corporate crisis, initially, a strategy crisis evolves, which then leads to an earnings crisis and shortly after turns into a liquidity crisis. If it should come to this, then one has to remedy the liquidity crisis on very short notice and with the utmost of concentration, and then bring the earning structure back in order so that strategy work can be resumed.

Regarding family-run businesses, there is a further condition for strategy work to be emphasized: The ownership of the company must be sustainable. In cases where there are more shareholders, this includes a trustful co-operation amongst the shareholders. There must be no open, irreconcilable area of conflict and there should be no threat of major capital shares receiving notice to terminate. Further, the processes of the share transfer to the next generation either need to be not currently in progress or already organized well in advance; In this context, the issues of succession in the corporate management and governance must be laid out. Only then, when the foundations of the company are clearly regulated, can the necessary decisions be made for strategy development, and resources for company development be deployed.

3 What Is Our Business Model, Which Are the Profit Sources, and What Do the Financial Implications Look Like?

Strategy work requires an understanding of the business model. What is the core of the company's customer service? It is not about the unique character of its competitive edge. This holds a rare, special position. There are many successful businesses that are satisfied with being good. You should know what the customer is paying for and what the company thrives on. It is often not the larger transactions, but more the unspectacular services (such as maintenance or spare parts). And you should know what the specific success factors are which can ensure reliable and sustainable service.

4 What Is the Significance of Volume?

Family-run businesses often represent a corporate form in an industry sector of prevalently medium-sized providers, which face one or two larger corporations. These family-run businesses often have the impression that they are too small and that they need to grow. Occasionally, this constraint is also strategically justified: Cost leadership through volume leadership ("experience curve"). However, you must be careful with this strategy: Most successful companies are by no means the

largest. Moreover, it mostly does not depend on the absolute size of a company, but more on the size of its service units (plants). There is often a relatively large one within the specialized market, the "hidden champion." But there are also fragmented markets, in which location and customer proximity are more important. The significance of volume in relation to success is also a very important feature for understanding a business model. It is about clarifying some very different strategic constellations:

- Volume, as a strategic advantage, has no relevance in fragmented markets and niche markets.
- Minimum volume as a critical mass, without the need to continuously generate a higher production volume, which is sufficient in many markets.
- Significance of cost digression over the experience curve with undifferentiated mass production.
- Significance of tightening the supply volume in the interest of appropriate pricing—the success factor when dealing with luxury products.

The company management itself has to recognize the fundamental effects. Then it can explain these to the shareholders.

In connection with the volume, a market's growth rate is a vital strategic feature. Strong growth needs to be financed through a high amount of retained earnings. The question of how much more investment capital is needed for a certain amount of sales growth are proportions that every management knows and can work out for themselves.

5 What Could Lead to the Ruin of the Business Model?

A good mental experiment, in order to find out what the critical elements of a business model are, is the proposed analysis by Fritz B. Simon: What would lead to the business' ruin? One variation of this question is the search for the possible cause of a company losing its reputation in the market. These questions are to be reflected upon every few years; because on the one hand, there are no absolute truths, and on the other hand, the business model changes over time.

6 Which Other Threats Must Be Avoided at All Cost?

Except for the decay of the business model, there are risks, which could lead to permanent damage or even the downfall of the company. These should be written down. If you truly just focus on existential risk operations, the list is manageable. It would look like this:

- Loss of reputation in the market, due to quality deficiencies that harm the customers (hygiene problems, etc.)

- Dependency on one customer buying more than x% of total sales.
- Destruction of manufacturing plant X, due to fire (without alternative plants).
- Product liability lawsuit in the USA.
- Losses of more than x% of total sales or of owner equity.
- Bank loans of more than y% of owner equity.

Company management should have a clear perception of these possible existential threats to the company. And owners and managers should have clear limits for their actions in order to avoid unacceptable risks. If the company's management should not yet have gained a firm conviction hereto, then simply raising the question might already help ensure that the necessary analysis is made.

7 What Kind of Financial Structure Does the Company Need?

With respect to the risks of entrepreneurial activities, there are two hedging options: A strong source of positive earnings which is given by an excellent product which sells at premium prices, and/or a conservative financial structure. For the financial structure, it is necessary to determine a maximum net debt (total interest-bearing liabilities minus cash deposits and marketable securities).

The accessible growth rate corresponds to the ratio of retained earnings to equity. Retained earnings depend primarily on sales levels (and the payout ratio) and are only slightly affected by the financial structure of the company. However, the financial structure is influenced by the relation of "retained earnings to owner equity." An equity ratio of 50% of total assets, instead of the necessary 25%, sustainably reduces the company's growth by about 40%.

8 How Much Must the Company Earn?

It is only when the conditions of survival have been clarified; that one can deal with the good life. A good corporate existence does not require maximum profits, but you should still at least earn above average. Corporate governance should furnish the shareholders with information on what the average earnings in the industry are. These can be ascertained and documented. If that was not possible, this would be a critical sign.

The upper third of high-earning companies shows what kind of earnings ratio is possible. However, there is also a minimum rate of return that must be earned. The return has to be at least so high that growth with the overall market is achievable. Moreover, the return should be so high that more and more shareholders of successive generations find pleasure in their family-run business. We will follow up on this. Ultimately, however, low profitability alone hardly jeopardizes the existence of the company. That is why profit increase for the sake of profit is rarely a meaningful main concern of the shareholders in family businesses.

In discussing how to improve an insufficient profit level, one has to be aware that profit is an effect of upstream causes. It is about the causes: inadequate products, outdated performance technology, poor prices. The following upstream areas attributed to profitability need to be discussed: Market position, technology status, price premium for good customer service, and the like.

The reason why income is needed, and the effect that profit produces, is to strengthen the strategic potential for success, through market development, technological leadership, operative excellence—and growth. It is hardly of any relevance to the present generation, which attractive return or meager yield was achieved at the time of their grandparents. What has remained from the profits, the company's growth, is the fruit of previous generations.

9 How Much of the Profit Can Be Distributed?

The aforementioned questions were about matters that are important for the company. Now, the requirements important to the company need to be matched with the interests of the shareholders. The owner strategy and corporate strategy are to be synchronized. The combination of these two levels of strategy lies in the question: what interests the shareholders more, growth on the one hand, or paying out dividends on the other hand?

In order to organize and thus possibly avoid eventual conflicts of interest, it is a good idea to create a general guideline for the distribution policy. This precludes the need for a yearly negotiation of this sensitive issue. There are several criteria that are reasonable but are specifically developed for each company, such as the target capital structure or the necessary rate of growth (see Chap. 23).

Which range of activity should the company have? Besides demonstrating an understanding of the current business model, strategy work provides a framework within which the company can develop further in the future. Shareholders want to specify what kind of business should *not* be operated. After the war, the inclusion of arms may have been rejected; today perhaps products and processes which have a negative impact on our environment are excluded. One of the major courses set by strategy work is clarifying the question of whether the activity radius of the company is to be limited to traditional business segments or whether it can be extended to new markets or new activities. This clarification is not a matter of choice, but initially a factual analysis of the available skills:

- Must all financial capital and management capacities be concentrated on the company's traditional business area?
- Is the company earning what it should be earning?

When a company earns more than it needs to further develop its traditional business area, then it must look for new, worthwhile investment sectors.

10 How Much and Where Does the Company Need to Seek Growth?

To put it bluntly, in the long run, a family-run business cannot do without good growth. Normally, this already results from the increasing number of family members or shareholders. This figure doubles, triples, or quadruples from generation to generation.

The prosperity of the future generation is secured only by promoting the growth of the company. You obviously cannot triple the company's return on sales from one generation to the next, but you can very well triple its sales and thus profits—over time. Three children would need around 6–7% growth p.a. As potential revenue growth depends on the growth of equity, it would be necessary to retain profits in order to maximize growth.

If profitability is normal and the payout ratio is not too high, then the equity and thus the growth potential increase from 6 to 7% is, in any case, achievable. That would be enough to increase turnover eightfold within one generation. So far, all of this is assessable. However, it inevitably leads us to the next level of discussion. No market, in the long run, grows 6–7% per year. So, if a company does not want to increase its market shares beyond rational proportions, then it must open up entirely to new markets time and time again.

In order not to confuse the discussion of growth with the target for the next few years, one should not ask where the company should stand in five, but where it should stand in 25 years. This is precisely the time frame for the work to be done by the current shareholders' generation.

11 How Is the Dilemma Between Dynamic Development and Stability Solved?

A shareholder group, as investor community—as any investor—faces the dilemma: how much should be banked on the dynamic performance of the portfolio, and to what extent, and in which manner must the aspect of asset protection be considered? Safeguarding requires division and diversification of assets, either within the company or by investing outside the company. But also for this dilemma of decision-making, there are no absolute truths. The solution should reflect the situation-specific and personal beliefs of the shareholders and must be redrawn again and again. Only the following can be said with certainty: that does not work with stagnation. It always requires the renewal of the activities and growth. It is not a question of whether to grow or not, but only of *how much*. Further, it can be said: The shareholders themselves and only the shareholders can resolve this dilemma. Employed company managers cannot assume responsibility for defining the primary interests of the shareholders.

12 Which Transcending Business Interests Do Shareholders Hold and How Can They Be Taken into Account?

The family-run business is defined, among other things, as a group of individuals associated with kinship, the shareholders, who can directly influence the company (Sometimes there are also groups of two or three founding families). This influence is based on holistic personalities. Their interests may—and often do—extend beyond the interest in the capitalist system of investment. Corporate management should not dismiss these efforts as non-business related. The family has many benefits for management, such as protection against hostile takeovers, patience for long-term development, and usually also strong loyalty to top management. Company management should therefore not only accept but also support the idea that shareholders not only maximize the profit, but they want to convey that with their property they also want to promote good in the world.

13 Standards Can Be Developed for Many Strategic Issues

Shareholders need to practice how to formulate what they want, and set that in writing, in a manner understandable to the company management. Hired management, wanting to loyally follow the intentions of the shareholders, justifiably demand to have these intentions formulated for the *entire body* of shareholders. As the strategy relates to relatively enduring orientations, they can be described in standards and guidelines. The basic norms can include:

- Maximum debt ratio[1]
- Dividend Policy
- Minimum growth rate in connection with minimum debt (total debt freedom can be an indication of insufficient entrepreneurial dynamics)
- Maximum share of turnover per customer

14 Strategy Work Requires Ongoing Communication

There are companies which usually at large intervals of several years present and adopt the company management's strategy in a strategy meeting. Such a massive infusion of strategy usually overwhelms the family shareholder members. Strategy work has so many aspects that these can only be developed through ongoing dialogs over time. The shareholders have a right to it, but so do the company's management. The quality of judgment from both sides and mutual understanding improves, the more often the strategy is discussed. Thus for strategy development, it is really the

[1]These quotas—as is customary—should not be formulated in relation to the balance sheet total, but in relation to turnover. This reasoning is imperative, but would exceed our scope.

process of "strategizing" that is the aim and not the output of—e.g., financial targets. Strategy work is the platform with which a company becomes a family-run business and it is the basis for keeping a family-run business sustainable for generations.

Further Reading

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Profits as the Basis of Strategy

Hermut Kormann

1 A Mandatory Agenda Point

It is a mandatory element of the monitoring function of governance to review the profitability. Not only the profitability of the whole enterprise but also of its individual business segments. This review is essential both when the overall profitability is excellent as well as when it is insufficient. Without knowing the root causes of good profitability the board would not know which key conditions need to be met in order to continue the high profitability. Thus, in good as well as in bad times, profits are of the essence. Let us review what the key issues are in such a monitoring process.

2 A Key Maxime: Profit by Avoiding Losses

The first rule for making profit is to avoid losses. This may sound simple, but it is not. To meet this requirement, one has to know where the company makes losses. Normally the financial data report an average: The sales of all orders in a certain product category and the sum of profits. To identify the loss-causing leaks the board should ask the management to break up the average into discernible subsegments. We recommend splitting up the total of sales into four even quarters with the respective amount of profit and loss for each quarter. Of course, the profit is "after all cost." This is called "full costs accounting," "fully charged costing," or equivalent. Marginal costing with variable cost only is irrelevant for strategic considerations.

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Having this breakdown one can answer two questions: First, which segment is highly profitable? This is the fundamental profit source for our business. It reflects a certain strength this business has. There is no high profitability without quality and good prices. Maintaining and developing this strength is essential for sustainability. Maintaining strengths is more important than eliminating weaknesses.

The second question which is answered: Which segment generates losses, which are an indicator of weakness? Too much of a weakness can destroy good strength. Therefore, it is essential that the weakness resulting from losses is limited to an acceptable volume. Look at the portion of loss generating sales: If these are double-digit losses on sales, cost-cutting will not help. Either one can increase prices significantly or one has to eliminate the product segment—or the customer segment. It is always worthwhile to try a price increase before eliminating a business. Often the price increase can be implemented and the issue is solved.

After having decided on the route of action regarding the losses, we need to return again to the segment of the high-profit business. Perhaps the profit is too high and it is better to level the price to a reasonable profitability before the competitors penetrate our profitable niche and customers are frustrated. Keep in mind the possibility of giving our long-term customers a fair deal—they deserve it.

3 Profits Are Results, Find Out the Causes

Nobody can influence profits directly. Profits are the results of actions directed at the root causes of profitability. Thus, one has to work on the levers for costs, volume, and prices in order to get the effect on the profits. Take this into your reporting system. It is more important to report on the development of the important cause-factors than on the result (profitability). Key Performance Measures are items such as: material quote, sales per capita, and similar.

4 Profits Through Good Prices

There is no good profitability without good pricing. And there is no good pricing without good quality and customer service. When you can offer good quality, you are almost forced to ask for a slightly higher price than your weaker competitor. How should your customer otherwise know that you offer good quality?

An acceptable price level is under constant pressure to fall. Therefore, monitoring the price quality is a key information requirement. The ways and means are specific for the various lines of industries. Rough approximation is better than not monitoring at all. A "quick and dirty," but fairly reliable test of how the price quality is developing over time is the ratio of sales to material cost.

5 Profits Through Continuous Productivity Improvement

Personnel costs have been and will continue rising substantially and are not negligible anymore. Sustainable profits can only be assured by constant productivity increases. In the industries with assembled and engineered products—and these industries cover a broad range of items, from automobiles to sneakers—from two-thirds up to three quarters of a cost reduction potential stems from a more efficient design of the product which then allows a more efficient manufacturing and assembling process including higher levels of mechanization or automation. Thus, as soon as a new generation of products is successfully launched one has to start the next project of designing an even better and more efficient product.

6 Assessing the Viable Range of Profitability

Profits fluctuate during the economic cycle. In our ripe economies, we estimate that in a “normal” recession (not the COVID-19 case) the profits as a percentage of sales are reduced to one-third of the average across the cycle. This is the consequence of reduced or stagnating volume and increased price pressure. In the upswing and boom-periods, the profits should—of course—be above average, typically one-third better than average. Considering this, one realizes that good profitability is the best hedging insurance against drops in sales volume.

In cases where profits are significantly higher than they used to be, say twice the average, then most likely this is a very limited span of extraordinary profits. They might be the consequence of an exceptional demand for our products, a favorable reduction of the material prices due to fluctuations of raw material prices—such as oil—or movements of the currency exchange rates. Be careful then and do not base your plans on the continuation of extraordinary influences.

7 Assessing the Required Level of Profitability

The most important function of profits is to finance the productivity improvements (mechanization, automation) *and/or* the growth of the business. In family businesses, the share of profits distributed to the owners is always the smaller part of profits. The rate of profitability, therefore, sets the ceiling for the sustainable growth rate of the business. This is also true the other way around. All companies in high growth industries have to make substantial profits in order to maintain their position in the industry. In the long term, the equity of a company has to increase at the same rate as the sales and assets grow. The exact ratios depend on many factors (assets intensity, taxes, financing structure). Roughly speaking, one needs close to double-digit profit/sales ratio to finance a double-digit growth ratio.

8 Deploy Extraordinary Profits

Whenever a company enjoys extraordinary profits which are one-time windfall benefits, one should not plow back the funds into the "ordinary" business. These profits are best applied to cover extraordinary purposes: a major infrastructure investment, which does not have a direct financial return, a "savings account" for the retirement phase of the owner, for example.

In conclusion: One needs a strategy not only on how to generate profits but also wisdom and a strategy on what to do with the profits in order to keep the business healthy and the family happy.

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Investments Strategy for Stability and Development

Hermut Kormann and Birgit Suberg

1 The All-Time Relevance

One of the issues which is included in the annual agenda of each governance process is the capital investment program. There are several reasons why capital spending is regularly reviewed in any company. First, capital investment is a major element in the financing of the company. Safeguarding the permanent financial stability is one of the overriding priorities in the governance process. Second, the direction of the future development of the enterprise is reflected in capital investment projects. There are no significant productivity improvements or no major growth initiatives without related capital spending.

Considering the capital investment strategy one can and should distinguish different phases in the development of the business or business segments respectively: the initial growth, the steady state, the sustainable growth, the temporary recession, and the long-term decline.

2 Phase-Specific Strategies

2.1 Investment Strategy in the Early Phase

The initial phase of the development is often characterized by high growth rates: Going from five employees to seven constitutes 40% growth. Consequently, the investment needs are abundant. It is not their economic justification which is the

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problem, but the financing. Any ease of the financing issue, such as leasing, extended payment periods, and so on, is important. Thus, the key question is how much can we afford. In this phase, there are more top priorities than financing means anyway. The task of governance is to define sustainable financing. There is a critical transition between the initial high-growth phase and the subsequent phase. Initially, the depreciation amounts of the existing equipment can be invested in capacity expansion. Think of a truck transportation business owning ten new trucks with an average life of 10 years. It can finance an additional new truck every year by reinvesting the depreciation. Thus, it can almost double the capacity within 10 years. But then half of the depreciation of the then 20 trucks are needed for replacement of the old ten trucks. The same problem arises in retail chains which grow by opening new stores each year. Suddenly the first ones look outdated and need refurbishment. Without rapid adjustment to the conditions of the new phase, the company runs into trouble.

2.2 Investment Strategy During Steady Development

In the phase of steady development, the focus in governance is changed from the financing aspects to the capital investment aspects. There are two approaches practiced to develop a capital investment program: The bottom-up and the top-down approach.

The bottom-up process collects the specific investment proposals. This will almost inevitably lead to more projects and higher funding requirements than can be afforded. Thus, this approach necessitates an extended process phase of prioritizing and screening the individual applications. Ranking the projects according to their profitability would not work. One cannot calculate a meaningful profit return or needs to factor in questionable assumptions for the majority of projects anyway, e.g., pure replacement equipment, infrastructure projects, R&D projects.

The better approach follows the top-down direction. In this concept, lump-sum allotments are earmarked for broadly specified investment areas or investment purposes. Such areas could be Business Divisions or Business Functions or investment categories such as Innovation Budgets. Typically, the current depreciation amount is used as a benchmark for the normal amount of investment. For a more thorough benchmark, one needs the data on the fixed assets at acquisition value in relation to the respective output of the capacity, typically sales value. Then the standard or at least the minimum amount of investment is derived as a percentage of the fixed assets at acquisition value. Thus, even fully depreciated equipment, which does not generate annual depreciation expenses anymore will get a fair share of investment allocation.

In a phase of steady development, depreciation is the basis for the renewal of the existing assets base. This always assumes that the depreciation is covered by the prices for the goods and services; otherwise, the company will certainly run into troubles. But reinvesting the depreciation alone will not be sufficient. Add to this the

inflation rate for the equipment prices. Add further the effects of increasing the automation of the manufacturing processes. Thus, even in a stable economy such as Germany, the minimum average reinvestment rate would be around 110–120% of depreciation. The higher productivity of the new equipment necessitates that the output has to grow—even in a fairly steady state of the development. The need to renew and upgrade the assets base forces any company to an at least moderate growth rate. We tend to assume that this minimum growth is around 4% without inflation.

2.3 Investment Strategy for Continued Growth

When the company does not only achieve a steady state but continues to grow at an attractive rate, then a high rate of capital investment is needed too.

Providing for higher growth rates, the rule of thumb suggests adding another 100% of depreciation for each 10% of growth. To illustrate: For a 20% growth rate, we need capital expenditures in the amount of 110 of depreciation for renewal of the existing capacity plus 200% of the depreciation amount for the expansion, in total more than three times the annual depreciation. Only one-third of these financial requirements of 12 plus percent of sales are covered by depreciation earned. Another third needs to be financed by retained earnings. And the remaining third might be financed by loans.

2.4 Investment Strategy During Recession

Even for the most successful company, there will be a recession from time to time (usually within less than 10 years). The year before the recession hits typically generates the highest sales and profits. Therefore, ordering new equipment was easy. This arrives at the beginning of the recession. Now a drastic change in spending is required. One needs to cancel all already approved capital investment budgets. A completely new plan has to be developed, which covers vital projects only. One-third of the depreciation should be enough for such a minimum budget.

2.5 Investment Strategy in Stagnating Industries

Finally, there are stagnating industries—even on a worldwide basis. We can talk of stagnation as soon as the rate of productivity improvement in an industry, say 3% annually, is higher than the real growth rate of demand, say 2%. Then within each decade, one-tenth of the existing capacity has to be closed down. Stagnation also occurs in an industry if a new technology replaces the existing technology—as will be the case again and again in the transition of the automobile industry. In these shrinking industries, there is still business and even very profitable business, but for the capital investment strategy there is a simple rule of thumb: in shrinking

industries, one cannot afford expensive new plant and equipment. Owning aged, already largely depreciated capital stock is a real advantage.

3 Conclusion

There are seasons for the capital investment strategy. The strategy has to fit the overall development needs. And there are critical turning points. One of the critical turning points is the swing from high initial growth to sustainable, moderate growth. If this swing coincides with a normal macro-economic recession then the going gets really tough for company management. Ideally one would have prepared for such a change ahead of time. Good governance is helpful for such a preparation.

Innovation Strategy for Renewal and Growth

Hermut Kormann and Birgit Suberg

1 The Relevance

Innovation is the driving force for the successful development of the family enterprise in a dynamic economy. All important aspects of the business strategy have to be "somehow" included in the agenda of the board. The question is: what can the nonexecutive board members contribute to this discussion and what should, therefore, be the details of the board agenda? We visualize the situation of a normal board with a good portion of nonexecutive board members and the duty of supervision as well as advice. It should be noted that among the German family enterprises we are finding more and more "Strategy Boards." This strategy board is not involved in the supervision or the approval of annual reports or financial transactions. The strategy board acts parallel to the supervisory board. It deals with topics of strategic interest to the management and/or the owners of the enterprise and contributes its advice to those decision-makers.

The strategic aspects of innovation are twofold: First, it is about finding attractive options, which is a search and creativity process. Second, it is about balancing various other interests versus the interest to push innovation. This balancing act concerns the following trade-offs:

- Interest of high overall profits versus expenditures and investments in innovation
- Loyalty to the business tradition of the family enterprise versus promoting change to modern business models and diversification

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- Risk acceptance versus putting a halt to innovation projects which are not promising

Do not expect precise proposals or even the golden idea.

Before we review how the board should proceed in this matter it might be helpful and easier to state what should *not* be done or expected. It is not to be expected that one outside member proposes a concrete project for research or even a specific route for development of a new product. This is just not possible. Innovation work is a task of searching in uncharted territory. Often it cannot yet be sufficiently specified what is searched for, the option might only emerge during the process of searching. Such a process requires a regular and deep involvement of the executives in the process. These requirements cannot be met by board members who convene every second or third month only.

This situation is hardly changed if the previous CEO moves to the position of chairperson. Most likely he or she had the detailed involvement during their term of office—with the emphasis on *used to* have. This prior knowledge is soon outdated. Innovation is about future developments.

2 The Steps in Governance of Innovation

2.1 First Step: Agenda-Setting

Now let us see which are the positive functions the board can have regarding the innovation work. The first and perhaps most important task is to put the innovation strategy of the company on the agenda of the board. Putting an issue on the agenda of the highest institution in the enterprise, the board, indicates to everybody in the organization: innovation is an important topic. It is understood that such a topic of the agenda requires a report by the executive team. Such a report covers the status quo as well as the targets of the strategy.

2.2 Second Step: Reviewing the Situation and Monitoring the Development

Whereas each enterprise has established concepts for monitoring and evaluating the financial performance, we do not have a similar standard practice when it comes to the innovation performance. This is understandable. Financial accounting has been a core aspect of business administration research for more than 100 years. Innovation is a rather recent topic of research. Further, the benchmarks and issues differ across the various industries. However, at least some practices can be considered as useful in most cases. A very basic piece of information is to compare our patent applications with those of the competitors both regarding the area of development as well as the number and quality of inventions. Then it is useful to verify the age of the technology on which the currently successful business segments are based. If this

technology was already developed 20 years ago it might be very likely that the progress of sciences offers advanced solutions today. Another variation of this inquiry is to position the currently successful business on a life cycle curve. A further variation is to identify the age of the major resources of the manufacturing process. If these are older than a decade it is again very likely that more productive processes are available in the markets.

The analysis of the age structure of the current sales and profit base is a necessary element in understanding the situation. One has to fight against the "Innovator's Dilemma" (Clayton M. Christensen 1997) of being locked in by the success of the current technology. This success leads to complacency. Innovations always destroy existing assets and profit pools in order to secure more sustainable products and technologies. One has to fight against the risk of "rigidity," i.e., insufficient adaptability to new trends. Even if something is working perfectly, the innovative company starts to introduce renewed business concepts anyway—so as not to miss the time window when innovation is needed.

The important thing is to update these analyses on a regular basis using a comparable set of information.

2.3 Third Step: Forming an Encouraging Policy Regarding the Innovation Work

Reviewing the status and the targets reported by the management should lead to a joint policy formulation. The policy illustrates the importance which is attached to the innovation work. It is not always afforded the highest importance. For a smaller company, it might be too risky to assume the role of an Early Mover in introducing new technologies or deploying new equipment. Following the emerging trends might be more reasonable. Specifically considering the reluctance of customers in B2B-markets to rely on unique, single-source products. If however—e.g., for a Hidden Champion—the innovation advance is of utmost importance, it has to be pursued independently of the negative impact on short-term profits. Such a policy could lead to the separation of innovation budget which is eliminated from the financial performance measurement. This could further lead to specifying innovation successes as a separate item in the incentive scheme. The target-setting and the incentives scheme advises the executive team on the priorities of the principals. For the sustainability of the family enterprise, innovation and growth are more important than short-term profitability. This priority needs to be reflected in all elements of the governance process.

2.4 Fourth Step: Sharing Real-Life Experiences

In mature industries, a major innovation project can be successfully concluded perhaps just once in a decade. That means that the executive in his or her 1940s or 1950s will have participated in only two projects. This very limited experience could

be augmented by the experience of the senior executives in the board. This sharing of experiences could be helpful in overcoming the frustrations resulting from delays and setbacks in the process. This experience might encourage individuals to dare to experiment. Experiences gained in the field of launching the marketing for innovations could be transferable from one market to another market.

2.5 Fifth Step: Pruning the Portfolio

We underline the need for encouragement to stick to innovation projects. But there is also the risk of demonstrating too much patience in innovation projects. We can observe the loss aversion by avoiding to write off unsuccessful project expenses. To "save" these expenses by ever-new, increased, and costly efforts to force the successful "breakthrough" of the innovation. Here a realistic assessment is needed to avoid throwing good money after bad. But one should not blame someone for unsuccessful experiments. Specifically taking into account, that there is seldom a completely useless innovation project. In almost any innovation endeavor, one finds a novelty that could potentially be used in another context. Rather one can justify the elimination of unsuccessful projects by the positive argument that one provides space for new projects which are more promising.

2.6 Sixth Step: If Nothing Needs to Be Changed, Start an Innovation Project Anyway

If you think you do not need this complication of an annual review of your innovation work because your industry does not need that or because everything is running smoothly right now, then: Put innovation on the agenda anyway—you never know, perhaps there is a major thread or opportunity just around the corner. Innovation is always good luck, but one has to have to give good luck an opportunity to happen.

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Patterns of Family Enterprise's Growth

Laura K. C. Seibold

1 The Phenomenon

In the year of 1668, the Merck family had a small pharmacy with three employees. After a pioneering invention in the field of Alkaloid by Emmanuel Merck, the pharmacy started growing and during the second generation, the pharmacy developed into an enterprise with an industrial production of pharmaceuticals and chemicals. Over the years, the enterprise expanded and has developed into a multinational, well-established business group.

The Merck Story is one narrative of an almost 350-year-old German Family-Owned Business. There are many more old companies who can look back on a colorful past, starting with a small craftsman's shop, a pharmacy, or as a self-employed merchant. All of these stories have one thing in common, they all started small and have developed into a long-lasting family business. In most of the cases, the second generation started to establish organizational structures, after the pioneering innovation of the founder. We would like to explore the challenges of the second generation from a practical/action-orientated perspective. What are the development requirements of the next generation concerning the business growth in the different stages of the enterprise? In order to understand these requirements, our team has conducted comprehensive studies of the 350 biggest industrial family-owned businesses in Germany with a special focus on the transition from the first to the second generation.

We found patterns facilitating successful long-term growth as described below.

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2 The Rare No-Growth-Requirement

Of course, as we focus on the determinants of growth as a development need of the second generation, we have to acknowledge that in certain businesses, growth is irrelevant (or at least not essential). Growing is optional for a business if it has a monopolistic position such as a downtown hotel, a rare vineyard, or a luxury brand. The need to grow is also not given if the business operates in a highly fragmented industry (e.g., food and beverage industry). But, in all other conditions, growth is needed for sustainability. As our research reveals for the German businesses, the conditions of sustainable growth are:

3 An Upper Growth Limit After the First Generation

We found that all old family businesses which still survive have one important point in common. After the first generation, the growth rate was at a maximum not higher than 1.5 times the overall growth rate of the respective industry. We also found that the average growth rate over a period of 30 years did not exceed 10%.

4 A Lower Growth Limit

The growth rates of the family businesses studied were also not lower than 0.8 times the overall growth rate of the respective industry or some 2.5–3% annual growth rate (assuming an industry growth of 3–4 in mature economies such as Germany—and respectively higher in China).

As this long-term growth corridor has an upper limit, the achievable size of a Family-Owned Business is to a larger extent determined by the size achieved during the first generation or early in the second generation at the latest. Unless the founder-entrepreneur emerges from the stage of self-employed or small-shop activity to the size and organization of an enterprise, the ongoing development of the business is not assured. Thus, reaching the stage of a full-blown enterprise early in the second generation is fundamental.

5 Four Factors Are Essential for Supporting Sustainable Growth

For an understanding of the reasons for successful cross-generational growth, we need to look at four requirements as shown in Fig. 1: Need, Options, Capabilities, and Willingness.

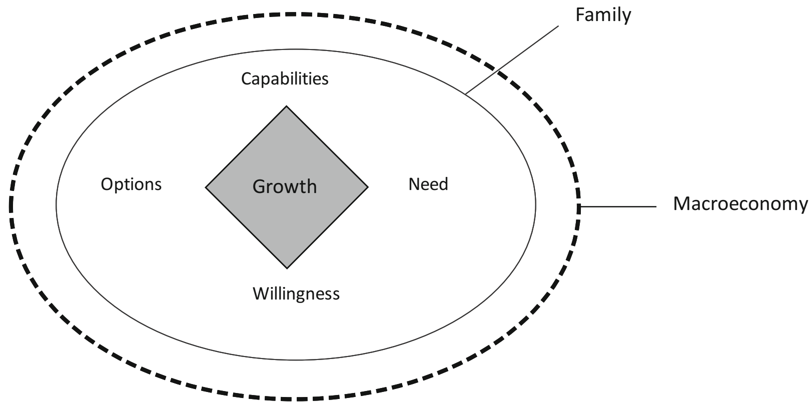

Fig. 1 Growth Diamond. Source: Author's own figure

5.1 Need

The necessity of growth has an organizational as well as an individual dimension. At the organizational level, the growth of the whole industry plays an important role and drives the need to grow the business. As mentioned, the overall industry growth is an important benchmark for the thresholds for growth. Another driver of the necessity of growth are the geographical dynamics of the respective industries. The overall macroeconomic situation determines the need to grow continuously.

From the business perspective, the most important benefit of growth is the gain of stability and thereby sustainability. These can be based either on a larger market share in a product-market-sector or—even more importantly—on diversification into several business activities. A long-term analysis of companies in the state of Baden-Württemberg between 1940 and 2010 shows that all companies with more than three divisions, i.e., diversified activities, survived over these 70 years.

On an individual level (family level), the necessity of growth is driven by family-specific issues such as the inheritance mode and shareholder expansion. As the number of family members increases, there is a greater need for the business to grow in order to satisfy the demands of all family members. On the one hand, this need comprises financial compensation in the form of dividends, etc. and on the other hand, this is the opportunity of an active career in the family business. As the business grows and develops further business divisions, it can offer any suitable member of the family a job opportunity. The increased demand for dividends can increase the need for growth but this demand could also be a threat to the company as it depletes the financial resources which are dedicated to financing the aspired growth.

The mode of inheritance is a further driver of the necessity of growth, as an increased shareholder base or the payout of shareholders can be the outcome. If the business is transferred to all heirs, the shareholder base expands and the issues stated

above arise: The increased demand for dividends and the possibility of an active career in the family business. If it is the case that the business is bequeathed to one child of several, then shares of the other heirs generally must be financially compensated, which indeed reduces the financial scope of potential growth opportunities for the business.

Therefore, transferring the business to one child only significantly curbs the desired growth. But it is a fact that there is no old and large company in the sole ownership of a fourth-generation owner. Those companies which are still in the sole ownership of one person, such as Faber Castell, many traditional hotels or famous vineyards, are comparatively small. Concentrated ownership requires cash outflow to compensate those heirs excluded from the inheritance of the business shares. According to German law, in case a descendant is excluded as heir by the will, he or she is nevertheless entitled to a minimum participation in the wealth of half the amount of the normal share. The challenge is that this half is to be paid in cash without delay. Such cash comes from the company's after-tax retained profit. This cash outflow reduces the growth potential by one half or two-thirds.

As a consequence, the founder should anticipate the succession management as it can cause tremendous impacts on the second generation's need to grow. And the second generation should align its growth to the industry situation using the above-mentioned corridor as a potential guideline.

5.2 Options

Following the growth needs of the family business, the growth options of the business, which arise in the second or subsequent generations are of equal importance. A distinction can be made between internal and external opportunities. The internal opportunities to grow are defined by the innovation potential as well as the amount of and access to financial resources such as reinvestment potential. External growth opportunities arise from changes in the market/product or the macroeconomic cycles and trends. During the last 40 years, German industrial companies have found their growth almost exclusively in export markets. In addition, the reduction of the time-to-market process and the contraction of the innovation—(substitutions)—curve open new growth opportunities. Also, taking over the market shares of declined firms in the respective industry enables new growth opportunities. Joint ventures, alliances, and networks—especially in an international context—yield opportunities for growth.

The practical implication requires that one should search constantly for internal and external opportunities for growth, deploying your own strengths as well as the opportunities arising from the macroeconomic surroundings as this is the starting point for any growth. Maintaining contact with an external network and building up partnerships could help to overcome any weaknesses.

5.3 Capabilities

To pursue the above-mentioned options special capabilities are needed. One of the most important factors influencing the capabilities for growth are the human resources. The willingness to take risks and a proactive orientation, especially of the top management team, are key drivers of growth. Also important is the ability to communicate and implement the decisions derived from the entrepreneurial orientation to the employees—the leadership style. Besides talent, organizational capabilities play an important role in the growth process, such as the time of adaption to external and internal changes as well as the financial stability.

One favored and commonly used step to enhance the financial capabilities for growth is an IPO. But our research reveals that an IPO is not needed in order to grow into a large company. Empirical evidence shows that in Germany there are three times more non-listed Family-Owned Businesses with more than one billion EUR sales than listed ones. Furthermore, the growth rate of non-listed Family-Owned Businesses is higher than the growth rate of listed Family-Owned Businesses and Public Companies. It is a fact that the higher dividend quota of listed companies reduces the sustainable growth rate. Therefore, the absolute amount of retained earnings in a non-listed Family-Owned Business is generally higher than in a listed Family-Owned Business. Further, the profit pressure by non-family shareholders might reduce the opportunity for innovative and risky projects.

Further, we found that no listed company older than 60 years with more than 600 million EUR revenues is still under the dominating influence of the original owner family. This is a frightening finding as already 100 years ago family enterprises such as Siemens and many, many others made IPOs. They either disappeared, were sold or collapsed, or survived with the original owner family's participation reduced to a negligible portion.

Practical considerations require that you respect your own given resources. For a medium-sized family company, the commandment applies: "Don't play where the elephants dance!" Restrict your growth aspirations to an evolutionary path in line with your financial strength. Strengthen your financial basis initially by retained profits.

5.4 Willingness

The final point to discuss is the willingness to grow which stems from personal experience, characteristics, and the surroundings, all of which shape the goal-setting concerning growth.

Expected outcomes of growth strategies influence the growth willingness. The motivating forces are the monetary reward and increased independence as well as improved reputation based on the size and market position. Personal experience in other growth-orientated companies can facilitate the decision-making in the family business as well as the personal experience of mentors and of members within networks. Characteristics such as entrepreneurial orientation (innovative, proactive,

risk-taking) are important drivers of growth in the business. The personal experience and the characteristics are shaped by the family and their goals, needs, and concerns. Especially for the second generation, the goals of the founders' generation are still strongly prevalent. Many founders decisively convey and assert their attitudes, strategies, and goals to the offspring who succeed them. Due to the strong presence of the founder, it is challenging for the successor to establish his/her own attitudes and goals in the business strategy. This is one of the reasons why they prefer the sole ruler principle also for the next generation. One reason for these strong convictions is the desire to maintain the goal of double-digit growth in subsequent generations.

Having analyzed the 350 largest and oldest German family businesses, we have not found one company that was able to achieve double-digit growth over two generations or more. In fact, with the exception of the American oil companies—which had the sales growth based on rising oil prices and mergers—there are hardly any companies at all which were able to achieve a double-digit rate over 100 years. In Germany, the closest case is Robert Bosch with some 9% average growth rate over 125 years. Equivalents in the USA are Koch Industries and Mars.

Potential causes of this observed phenomenon could be the problem of overstretching the organization, as a real growth rate beyond ten or more requires increasing management resources at least by a factor of two each decade.

Another reason is the financing mechanics of growth. The first generation lived frugally and invested the full cash flow into the expansion of the business. In the second and subsequent generation, the growth is reduced (compared to first-generation growth). In the second generation, the factories and business assets developed by the first generation have to be renewed, refurbished, and so forth. Therefore, the cash flow has to be split between renewal without growth and growth investments. Furthermore, the second generation might follow a more cautious business strategy.

From the third generation onward, the growth is achieved to a large extent via Mergers and Acquisitions. Whereas organic growth can be financed at book value of the assets, growth via M&A implies purchase prices of two or three times of the book value.

The practical conclusion implies that one should be careful when setting quantitative goals, specifically one should be cautious with basing targets on the high targets from the high growth record of the first generation. Rather shape the growth orientation in qualitative terms. Growth is an evolutionary development.

6 From Enterprise to Entrepreneurship: Reintegrating Entrepreneurship

Matching these development needs is quite an achievement. Successfully doing so can result in a well-established, sizable, multinational enterprise. As the company matures, organizational routines are established and markets are saturated. In this life cycle phase, growth rates often stagnate or decline. However, some mature and well-established firms show growth spurts even in this stage of the life cycle. Through our

examination of the 100 biggest Family-Owned Companies in Germany, we see that 20% of them showed growth spurts even in later generations, primarily in the third generations, but some even in later generations.

Up until now, we have only preliminary indications on the causes enabling such mature companies to experience growth spurts. One must assume that later acceleration of the growth development requires an increased entrepreneurial effort. Typically, it implies reaching out to "new" areas—which include new know-how base and innovation of new business models. We can also observe opportunistic acquisitions of available unrelated companies that can open up new routes of further development.

Pursuing such growth initiatives is a long-term effort. This needs to be supported by a long-term perspective of the top management. For a non-family executive, the expectation of a long tenure is necessary to create a long-term perspective. Combining the long tenure with an appropriate incentive system and virtual share options might lead to higher commitment and support the realization of entrepreneurial orientation. The long tenure is equally important when employing family members. Family members in management or on the board with emotional engagement and entrepreneurial attitude can be vital to promote the renewal.

Besides willingness, another important factor in promoting growth spurts is financial resources. Therefore, freedom from shareholder value pressure by financial markets is necessary.

The search for growth opportunities is an emerging field with an intensified focus in practice and science. Research and consulting topics such as innovation strategy, design thinking, intrapreneurship, reorganizing the innovative potential of the organization are all indicators of an increased emphasis on strategy.

All these trends and initiatives could be interpreted as efforts to integrate entrepreneurship at the management level.

In conclusion, the demanding challenge in the long-term strategy of a Family-Owned Business is developing the growth path. There is not a simple key success factor enabling a family and its company to pursue a growth path. It requires a particular mindset and a fit in four major dimensions: Willingness, Need, Options, and Capabilities as well as their realization on the management and employee level. It is worthwhile exploring the interplay of these influences.

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Avoiding Unacceptable Risks

Hermut Kormann

1 The Relevance

We assume that each real family business owner has the vision to transfer their business to the next generation. Transferring it as a viable business and as an independent company capable of finding its own way to the future. What could prevent this vision from becoming reality is *not* earning less than the market leader. The risk is *not* posed by investing so much in good assets or in the infrastructure of a business that the Return on Capital Employed is reduced. The risk which could lead to the downfall of the company is posed by mistakes; a series of minor mistakes or one big mistake made by an already weak organization. Thus, the first priority to secure sustainability is to avoid big mistakes. We have statistics on the causes for the downfall of businesses: The top reasons are categorized as "management failure" or "lack of liquidity." These explanations are not instructive. They are too general. Which are the root causes preceding these consequential events?

There are three categories of negative events endangering a company: deteriorations and big failures are two of them, but there are accidents too, which are—almost—beyond our control. Let us illustrate the specific features of each of these threats by examples.

2 The Continuous Deterioration

The case of continuous deterioration is seldom an obvious and almost never an urgent problem: Seemingly there was nothing wrong with this company, a regional brewery. Certainly, it had to struggle for the profits each and every year, some years

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were better, some were worse. This could be easily explained: the weather was sometimes advantageous, sometimes disadvantageous. Some years the output grew by a few percent, some years there was stagnation or even reduction. They did not have a liquidity problem. There was not that much investment needed. Further, one could sell some idle real estate that the company owned. But, all of a sudden loss showed up in the profit and loss statement. They called in a consultant. The team identified huge investment requirements to bring the brewery equipment to a reasonable productivity level, but this would have increased the capacity for which the market demand was not there anymore as the market share has been shrinking for some time. They were lucky that they could sell the company to a large competitor. It closed down the facilities and served the market from its central, modern plant.

Another company in the B2B business once had with its engineered products an almost monopolistic situation. Then they faced increased competition. They counteracted this by offering special high discounts to customers. Initially, these were just a few deals, but they grew more and more. Finally, the general price level did not cover the costs anymore. Tight cost-cutting programs were the consequences. This could not avoid losses, however, and the company had to cease business.

What could possibly be done in order to realize the trend of deterioration early enough to start countermeasures in time? The problem in these cases is to identify early the seriousness of the trend. These examples of loss trends are similar to a fire. Detected early enough one can extinguish the fire. As time elapses, the destructive power of the fire increases until it grows beyond control. Some practical ways to gain insight early enough could be the following analyses:

- Compare all your business data with the data from 5 years ago. Do not take the data of the 5 consecutive years, but just that of the 5th year back. Compare the sales per capita and profit ratio to sales and all relevant data in your kind of activity and check if there is stagnation or real progress.
- Choose one company which you consider to be an example of good management. It need not belong to the same product–market category. It is sufficient if it belongs to a similar industry (B2B). Compare the trends in your business with the trends in their data over the years.
- Break down the total sales of your business into four groups of profitability: Sales with the highest profitability to those with lower profitability. Calculate in full cost to get profit and loss, not contribution margins only. Check whether the portion of loss-generating sales is increasing or decreasing over time. Work on the reduction of the portion of loss-making sales. To some extent, the difference between companies of good overall profitability and low profitability is not the difference in the cost level, but just the difference in the portion of loss-generating sales.

The deterioration problem can be cured if detected early enough and the treatment is decisive. Of course, more is needed than just the will to manage. One needs creativity to improve a product, one needs highly motivated employees to build good

relationships with the customers, one needs discipline and extra efforts to get a reputation for reliable performance. If one sees the need for improvement clearly, then this can push the motivation to change significantly.

3 The Big Mistake

The category of "big mistakes" is even more dangerous. There is no room for trial and error. The first big mistake could be a fatal one. There are contracts which could imply unlimited obligations. There are sales projects which are too large compared to the capacity of the organization. Think of a situation that someone offers you the opportunity to make one deal for the delivery of your products in the order of magnitude of 1-year sales or more—at marginal prices—and you are really not sure whether your organization can solve all the technical requirements involved. Or think of the option to acquire a company that is almost as large as your acquiring company is. In very general terms one tends to assume unlimited obligations when one acts in an area in which one does not have any experience for the first time. Entering a new market first time is such an area without prior experience. Entering a new market with a new product is risk multiplied. Then one lacks the competence to assess the risks realistically.

Paradoxically the risk of falling into the trap of incompetence or underestimating a risk is highest for those entrepreneurs which have been very successful. Success creates overconfidence. It can lead to the conviction that one can accomplish everything and anything. Underestimating the danger results from the false logic of assessing the danger by the standard-formula: Risk is the product of damage amount multiplied by the probability of occurrence. In strategic, one-off actions, one cannot work with probability-percentages.

One does not make a mistake purposely. Nevertheless, wherever possible, one needs to take precautions in order to reduce the likelihood of falling into the trap of a big mistake. The first exercise is to assess the danger realistically. To achieve that, one has to evaluate the "worst case," the maximum possible damage. An action that could eventually lead to an existence-threatening risk is a taboo. Second, one can train oneself to increase the diligence of one's work whenever one acts in unknown territory. One can approach step by step. One must not hurry under time constraints if one does not have experienced routines. Working in a team is one of the means to increase the know-how and the diligence.

4 The Accidents

Then there is a third category of danger. These are accidents: sudden, externally caused, damaging events. The COVID-19 crisis is such a very destructive accident. But there are more frequent, mundane examples. If fire destroys the major production unit, if your major customer goes bankrupt, if a new regulation eliminates your market, if a new technology makes your product obsolete. These are events beyond

your influence. However, insurances are there to compensate at least portions of the damage. Analyzing the risk is the way to find some protection and to learn where one has to be specifically cautious.

One strategy to prepare for any kind of danger is proposed by the writer on strategic thinking, Kahnemann: He labels the exercise "pre-mortem-analysis." List all those events you can think of, which could endanger the existence of your company. And then figure out which protective measures are conceivable. This is not an exercise to make you anxious. Quite to the contrary. Being aware of the—few—really essential dangers sets your mind free to assume the normal risks of entrepreneurial activities. This exercise should even encourage you to take affordable losses, because this is the entrepreneur's art and mission.

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Compliance and Environmental Protection: CSR in Family Enterprises

Hermut Kormann and Birgit Suberg

Most of the topics of governance covered in earlier chapters were related to the positive guidance of the business operations. There is however an additional, completely different, reason for governance: To avoid wrongdoing, the violation of laws, damage to stakeholders, to the civic society or to nature.

In this respect, the responsibilities of the management have been completely changed. One or two generations ago, it was possible that the management of a globally active enterprise, specifically a medium-sized family enterprise, would have kept a neutral position regarding different practices in the different regions of the world. “When in Rome do as the Romans do!” Thus, the standards for doing business in Brazil were left to the management of the Brazilian subsidiary. They knew what the Brazilians do in Sao Paulo.

Such a sloppy attitude would no longer be accepted in the modern world.

Knowingly violating the law cannot be reasonable under any logic. In some jurisdictions, such as the USA, the practice of punitive damages poses incalculable financial risks. In many cases, the violation of legal stipulations entails consequential claims for damages from customers. Further, the ensuing reputational damage could negatively affect the development of a company to a much greater extent than the payment of fines.

Similar multiple penalization could arise from negligent operations that damage the environment. To wrap up: Today compliance is a mandatory prerequisite for any successful development of a company. Given this relevance, the issue is then what contribution governance can and should make in order to prevent compliance violations. An approval right for the supervisory committee would not work.

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Management does not ask for the approval of illegal or dubious actions. Still, the following instruments and tasks can aid the governance system in its installing and monitoring of an effective compliance policy:

- Initiate the issuance of a clear zero-tolerance policy.
- Initiate a state-of-the-art risk reporting system.
- Verify the effective functioning of internal controls and audits by requiring oral reports from responsible heads of these departments at regular intervals.

In our countries, an effective compliance management system necessitates the appointment of a neutral ombuds-person. This is typically a lawyer who is obliged to keep strict confidentiality and work as an independent professional outside the hierarchy of the enterprise. He or she is available to be approached by employees who have concern about a critical practice or are somehow personally involved in a questionable act.

The ombuds-person can follow up on the issue with the company management without disclosing the source of the insight.

All these instruments cannot completely rule out willful wrongdoing. However, they are sure to act as a deterrent and thereby reduce the risk. Anyway, the biggest failure the management could make is to assume that its company is completely protected against such misconduct. No larger organization can completely guarantee the orderly conduct of all its members.

Of course, such preventative measures entail a certain bureaucracy. They should not be interpreted as the general assumption of mistrust. Ensuring this requires appropriate communication on the values of the company, i.e., indeed the values of the family, and the importance of the spotless reputation of the company.

Recession Management for Coping with Economic Cycles

Hermut Kormann

All over the world, companies prepare a budget for a new business and guess what the business activities will be like next year. Strangely enough, we tend to assume that starting a new year will not alter anything. What should change between December and January? Hardly anything! As a matter of fact, however, there are always changes imminent in the markets of any business. In this context, seasoned owners and their managers are analyzing if and when we will face an economic slowdown again. Of course, we do not know when a recession will come. But we do know that we will have a recession again as we have had in the last 150 years of industrial development. And we took it for granted that we would see the next recession by the end of 2018 or earlier. How did I know? Because every generation during the last 100 years has had the experience that there was a recession within a period of 10 years—of course with the exception of the war periods. In Europe, the end of the previous recession periods was 1984, 1994, 2002, and 2009. 2001–2002 was a very mild recession—most likely because exports to China were already helping to balance the demand. The recession of 2008–2009 was a very deep, but at the same time very short, recession, due to the substantive infusion of money by Central Banks and Governments all over the world. And 2019 the next recession just within the 10 years cycle was due, but it was 2020 that the COVID-19 crisis hit the world economy. This pandemic caused a downfall by itself. The normal recession came afterward.

The recession is a reduction of demand compared to the overall trend of the regional or industry market. This reduction hits even the countries enjoying a long-term growth trend. Thus if you are in a region—such as China—riding on a trend line of high growth, say 8% on average, and the industry-specific downswing in a recession is about 10%, then the net result of a recession is an effective reduction of

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the demand by 2%—compared to previous years. 8% trend minus 10% recession impact equals minus 2% overall development. Now, in Germany, we have a trend line of 2% of growth of the Gross National Product. A recession means then a reduction of the effective demand of 3 minus 10 equals minus 7%. This is a real reduction. This cannot be compensated by intensified efforts in the sales department.

There are differences in the reduction rate between the industries: Less in supply to the Governmental investment programs, less in basic consumer demand such as food, higher in the markets of durable consumer goods such as furniture, kitchen equipment, and cars. It is the highest of course in the machinery and other capital goods markets for industrial customers. Obviously, the recession means for the investors a profit squeeze and they cannot afford to spend too much on capital investment. Furthermore, the years immediately before the recession are the best years in that decade, which is why the firms have been very generous in their capital equipment spending in those years. This increased capital stock is not used any more to its full capacity in recessive times. Thus, one does not need additional equipment in the short term. In summary, there will be a sharp reduction in demand for capital goods.

The recession requires a specific managerial approach. We use a metaphor: The difference between normal management and recession management is the same as the difference between normal medical practice and emergency medicine. Under normal circumstances, the doctor runs some tests of your physical condition, reflects on the findings, makes a diagnosis, and then decides on a treatment. The emergency medic does not have time for diagnosis: He or she has a clear sequence of priorities: First clear the airway so that the patient can breathe, then stabilize the blood circulation and: Stop the bleeding. The priorities in recession management are similar. First thing: secure the reduced order entry. Second: stop the bleeding of any loss activities you have. You could afford some loss orders during the good times, but one has to stop any loss generating sales at too low prices. When the volume is lower, at least the acceptable price level has to be kept. Third: stabilize cashflow—for example, by reducing your capital investment.

This is why business needs a recession from time to time. One gets a proper training in management for a crisis situation. Sooner or later each company will experience a crisis for whatever reason. COVID-19 was such a reason for most enterprises. The very successful entrepreneur who has been lucky all the time carries a very high risk of lacking experience in crisis management. So, for the family business management a small dose of a crisis, such as a normal recession, is really helpful. It offers invaluable experience in preparation for really difficult challenges.

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Fighting Financial Squeeze

Hermut Kormann

In one of the preceding chapters, we covered the "financial planning" for the mature enterprise. Even there the financial planning and strategy is a function of high importance. Here, we talk about financing the young enterprise in the first half of the first generation. In this phase, financing is of utmost importance: Financing can be decisive for survival. Why? The overriding phenomenon during the first generation is growth. The founder started a small business, a very small one. It can grow and *has to* grow at a high rate. Otherwise, it will not be sustainable over the generations—and then there is nothing left to analyze. To be able to grow at high rates of more than 10%—up to even 20 or 30%—one needs a high growth of the equity. In a family enterprise which wants to maintain its independence, this growth of equity can only be sourced from retained earnings. And for high retained earnings, one needs high profit rates to start with. For a 20% growth rate, one should have around 15% on sales. But this is only the basis for being able to raise loans at the rate of the growth rates—year on year. No easy task. To cut a long story short: Almost each and every founder of a business is in a constant financial squeeze. Therefore, financing is a topic which has priority on the agenda of a board for a first-generation business.

What is the role of the board in such an uncomfortable situation? The easy way would be to stick to conventional financing rules. Such rules could either reduce the growth rate or ask for additional equity from third parties (e.g., Venture Capital, Private Equity, Going Public). In the latter case, the family owner loses to a greater or lesser extent their independence. But most likely the board was established in order to safeguard the independent development of the family enterprise.

Therefore, the second task of the board would be to make clear to the owner how important it is to stay independent. For the first-generation owner is would be almost

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impossible to buy back an equity-portion that had been sold to Venture Capital or Private Equity. Of course, going public will not lead to the end of the Family Business immediately—but it doubtless will in the long term (see the subsequent chapter B 11).

The third task could be to reduce the financing needs by reducing the investment. Leasing is to be preferred to buying and financing, renting is preferred to owning real estate, investment is provided only for the short-term requirements, no funds are tied up for only long-term required reserve land or buildings or equivalent infrastructure investments. "Invest as you earn" is the mantra.

There is nothing wrong with being parsimonious with investments. Thus, the board might—reluctantly—accompany a financing strategy that leads to a fairly leveraged debt structure. Even in such a situation the natural tendency of the owner or the CFO might be to save on the cost of financing. This, however, is not the real problem. Repayment and refinancing of the debt are the problem. The board should concentrate on mitigating the risks of the high leverage. One option is to choose long-term financing. In addition, the company needs to stagger the repayment dates.

But—summarizing everything—there is still a high risk-exposure for the young enterprise and its owner or owners. Therefore, a responsible board will care about the financial security of the owners. This can in such a constellation only be provided by financial resources outside the company. This is an important aspect. Often the owners try to build up financial reserves inside the company—perhaps by investing in the financial markets or in real estate. This is no risk diversification. Therefore, the paradox requirement is to channel liquid funds out of the enterprise to the private savings account even in a situation of a tight financing structure in the company itself. Owners are reluctant to accept that. But that is the reason that they should seek an advisory discussion with an independent board.

The logic for these priorities is supported by the scenario planning for the case that things develop from bad to worse. The enterprise faces the risk of illiquidity. Hopefully one has a good relationship with a trusted bank that has been accompanying the enterprise for a long time already and has confidence in the restructuring plan. However, it is willing to finance this plan only on condition that the equity owners contribute "something" to the refinancing, too. The equity owners can do that only if they have "something" outside the company which they can now transfer to the company funds again. And if the enterprise does not find such a lender of last resort, then the owner had better have something outside the company which can provide a financial basis for retirement. In most countries, there is some kind of protection for the pension plans of workers and employees. Obviously, such plans would not allow the main-finance of the standard of living of the owners and in any case, the owners would not qualify for such plans. They have to take care of their retirement themselves. And the board should remind them to do so.

The Trade-Offs of Mergers and Acquisitions

Hermut Kormann

1 The Relevance

We emphasize that a governance board with non-executive members of the board is a safeguarding instrument. The functions of the advisory role as well as the risk evaluation and approval are highly important when dealing with a request to launch an acquisition of another company. The non-executive members, however, have to carefully balance scrutinizing a proposal for hidden flaws against encouraging the management to pursue promising projects and accepting justifiable risks.

The following reflections cover some key issues. An acquisition is considered to be successful if the buyer is better off with the acquisition than without—some 10 years later.

2 Profitability

We take it for granted that the acquired business is fairly profitable. Certainly not as profitable as indicated in the sales memorandum. This, however, does not destroy the logic of the acquisition provided the price is properly adjusted. And this will always happen.

In order to assess the profitability of an acquisition, in some cases, one has to look beyond the current profitability of the entity itself. This is the famous case of synergies. Synergies can potentially be found in two different areas: One is the profitability of the acquired entity, the other one is the profitability of the acquiring entity:

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- We would not propose putting too much faith in the usual synergy calculation, i.e., how the profitability of the acquired entity could be improved. Typically, one refers to the know-how and to scale effects from the acquiring company in order to increase profitability. To the extent this is possible, it is usually necessary to compensate for unforeseen negative influences.
- More important might be the effects of the acquisition for the acquiring company. The first positive effect might be that a potentially negative effect can be avoided. The relevant question is: What would be the consequences for us if our most dangerous competitor acquired the target entity? Such an analysis could lead to the decision that even a fairly high price for the target might be justified. This is specifically true if the acquisition protects us against the increase in the marketing power of our competitor.
- Another additional consideration is the question: To what extent does the acquisition open up the opportunity for complementary sales via the newly acquired sales channel or based on the know-how and/or products gained from the acquired company? Some prices paid by Chinese acquirers for European companies might be based on such considerations of complimentary business opportunities. The know-how of the acquired company can improve the traditional product range of the acquiring company. The existing global sales network of the acquired company can generate additional sales for the acquiring company.

Developing such additional opportunities can take some time. Therefore, it is wise not to include overly optimistic improvements into the feasibility calculation of an acquisition. Anyway, the success of an acquisition cannot be evaluated on meeting the forecasts. Even if the acquisition of a promising business is expensive, 20 years later only the development of this business is of the essence—nobody will recall the price anymore. Thus, the strategic point is: Can we afford the basically reasonable acquisition?

3 Financial Affordability

The affordability depends on the answer to the question of whether, and from which sources, the purchase loan can be repaid. The equity of an acquiring family business remains unchanged. The purchase price is financed by loans. These loans have to be paid off until a sustainable level of debt is reached.

Loans to the amount of a certain portion of Working Capital is a sustainable level under conservative criteria. This, however, is less than one-third of the total acquisition financing. Two-thirds are most likely to be for the acquisition of the equity, for which the price might be—as we assume—two times or two and a half times the book value of equity.

In a steady state, the equity of the acquired entity should be permanently financed by equity and not by loans. Why? There will be a crisis at some point in time. At that point, one needs equity as a contingency reserve. Anyway, let us assume that the terms and conditions of the acquisition loan require a repayment of two-third of the

loan in annual installments within 10 years. At 6% interest this gives an annual amount of some 13.5% of the loan portion which is to be repaid. This plus the interest on the permanent one-third of the loan gives about 11% annual payment.[1]

Now let us specify exactly which source of liquidity can deliver such amounts. Of course, ultimately the acquired entity has to repay its own purchase price. The acquired entity makes perhaps that much profit—before or after tax? But, first question: Do we have access to the cash flow for full distribution or can or must the entity retain a significant amount of this cash flow for financing its own restructuring or its own expansion? If this is a listed company or if there is another partner in the business, i.e., we have less than 100% of the shares, we cannot distribute all the cash flow or load the entity with the loan burden. This is obvious. However, there are numerous cases where the acquirer thought he may have access to the full cash flow but did not in reality have it.

In all likelihood, the acquired company cannot repay the loan fully; the balance will come from the ongoing business of the acquiring enterprise. Now we see the two sacrifices the shareholders of the acquiring company have to contribute:

- First, they need the full distributable profits of the acquired entity for 10–15 years in order to repay the equity financing of the acquisition of the entity. This means: The shareholders themselves cannot enjoy an increase of profit distribution from this new, acquired source within that time span.
- Second, the ongoing "old" business has to finance any gap in the loan repayment and provides its own credit base as collateral for the acquisition financing.

This, again, is obvious. Nonetheless, more often than not the strategic consequences are not spelled out clearly and understandably.

Anyway, in order to think through the consequences, we need to simulate what the accounts would look like after a potential acquisition. In analyzing this enlarged, consolidated statement some aspects are to be highlighted:

- The total sales and total assets are increased by the acquired business.
- The equity is not directly increased. It will only gradually grow by the retained profits. As mentioned, these retained profits are used for repayment of the loan.
- As the purchase price is tentatively two times (or three times) the book value of the acquired company´s equity, there will be a goodwill capitalized in the consolidated accounts.[2] When the next recession or economic crisis arrives, the current value of this goodwill will be reviewed. One has to be prepared that a significant portion of this immaterial assets has to be written off as expenses. After a relatively large acquisition (compared to the size of the acquiring

[1] $11\% = 13.5\% \times 0.66 + 6\% \times 0.33$.

[2] Goodwill is the difference between purchase price and book value of the equity of the acquired company.

enterprise), the risk of a goodwill revaluation can cut off a significant slice of the equity. This is clearly a risk.[3]

These considerations give some indication as to the feasibility of the acquisition if the acquired company develops more or less as expected. The full strategic analysis requires an additional perspective. Which consequences follow from the acquisition for our existing business? Can we afford a failure of the acquisition? We will address these further steps of strategic thinking in the following paragraphs.

4 Trade-Offs and Risks

What is the impact of the acquisition on our existing business? We have already discussed the fact that the total assets are expanded while the equity remains unchanged. This, as well as the repayment of the acquisition loan, put a burden on the financial capabilities of the acquiring entity. So much for the financial resources. The same effect applies concerning the Human Resources. For integrating, restructuring, or expanding the acquired business, one needs leaders. One needs some tested and proven executives from the existing operations to be assigned to the acquired entity.

When Daimler acquired Chrysler, the merged group had to launch a crisis management program together with an overhaul of the product range at Chrysler. All of their Stuttgart experts were involved in these programs in Detroit. One of the most costly and dangerous consequences was deficiencies in the quality of the E-class-cars from Stuttgart, the profit base of Daimler.

In summary: There is a clear trade-off between organic growth of the existing business and external growth by acquisitions. Acquisitions deploy the financial and executive resources of the acquiring business. That means: These excess resources have to be there in the first place.

In this context we have clear evidence from the analysis of the old (third generation), high-growth (more than 10% growth per year) family business enterprises in Germany[4]: They grow organically, with hardly any acquisition (with just one enterprise following another strategy). One could say: with high organic growth one does not need an acquisition. The other version of this conclusion is true as well: A high organic growth does not allow a high external growth. It is a trade-off.

In any case: One has to have a solid, profitable existing business in order to be able to meet the requirements of high external growth. This is underlined by the following final test of the affordability of growth: Can we afford to fail in the project?

[3]The total good will in the accounts of the German DAX-companies (30 most important listed enterprises) is significantly higher than their equity.

[4]See chapter “Patterns of Family Enterprise’s Growth” above.

The ultimate acid-test for the acquisition proposal is: What will be the consequence if the logic of the whole deal turns out to be wrong? If the acquisition is a complete mistake, what are then our options? This analysis is a very useful exercise:

- If we can integrate the customers, products, machinery, or personnel into our existing operations, we can do that and close the acquired company. This significantly reduces the risk of a complete loss.
- If we can sell the acquired company again at a discount (perhaps to a Chinese investor) the loss can be digested. This risk is acceptable.
- The high-risk situation exists when it is very unlikely that we find a willing buyer for a resale. The start-up business which turns out to be a flop; the company in a developing country in which other local competitors are not interested. In cases like these, an extended restructuring or even liquidation program has to be executed. Continuing a loss-generating operation is no acceptable course of action.

5 The Summary

If a maturing enterprise runs out of options for the organic development of its business, it is likely to turn to external development impulses through acquisition. Also, if an enterprise needs diversification, e.g., as a hedge against risks in its existing business, an acquisition might be the advisable option. In these cases, available opportunities might be attractive, even very attractive. The attractiveness is, however, just the first level of analysis. The criterion of affordability of the risks involved is of equal importance. The higher level of risk stems from the circumstances of the deal.

The buyer knows less about the target than the seller, the time for analysis is limited, the investment normally cannot be split up into smaller slices. It is a go or no-go decision on a large financial investment. These aspects do not rule out acquisitions as a feasible option, they just require an adequate logic of analysis—i.e., the worst-case approach. And then it requires protective measures to cope even with such an extreme scenario.

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The Trade-Offs of Going Public of Family Enterprises

Hermut Kormann

1 The Relevance

In some family enterprises, the question arises of whether going public could be a strategic option to support the development of the company. This is an issue that has to be dealt with by the shareholders only. However, this is a unique decision situation and the shareholders do not have any experience of their own as to the consequences of such a strategy. Therefore, the shareholders need advice. There are quite a few professional advisers on such an issue: investment bankers, lawyers, tax advisers, and others. There is hardly any professional who provides advice on the advantages of not going public. The role of the board could be to make sure that the shareholders get a full picture of the trade-offs in the prerequisites and consequences of an IPO, specifically in the long term. Such a checklist on the full picture should include the following criteria:

- Goals of the enterprise, specifically the relevance of the goal of "independence." Which effects are to be generated by the IPO?—and they can be very diverse.

Without going into too much detail, the following considerations should give an overview of how complex the long-term effects can be.

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2 Trade-Off Between "Independence" and "Motives for External Financing"

When defining family business, research assumes as one of the criteria that the owners have a dynastic intent. They want to create or continue a business activity that is sustainable and which survives economically so that the following generation can continue to develop the company. Ensuring the survival of the business is the overriding vision. Research gives many indications, that maximizing wealth is not the main objective. A focus on profit maximization could lead to assuming ever-increasing risks, which jeopardizes survival. Of course, a company needs a satisfactory profit level for development, but securing an acceptable level is something different from maximizing. Further, the owners are personalities who have wishes such as seeing their creative ideas implemented. They want to be recognized for running a company that is known for its quality, for its innovation, for its reliability. The reputation of the family is linked to the reputation of the company. And in order to develop the company as they want, they have to be independent. Maintaining independence is another striking element in the target system of family business owners. This is their entrepreneurial strength. They can pursue their convictions; they can spend a decade developing a new technology in which they trust. They can invest whenever they see an extraordinary opportunity. Those entrepreneurs who experienced a financial squeeze—and almost all business founders had this experience at least once in their career—want to avoid forever the dependence on banks or other lenders. In summary, the non-financial targets concerning the reputation of the company and independence in managing the company have a high importance in the strategy of family business owners. Why, then, do family business owners ever consider selling a portion of their company via an IPO to the financial markets or selling the company completely to an investor?

3 The Motives for Going Public

In analyzing the potential reasons for going public, the situation in Germany is taken as an example. Germany is largely admired for its class of wholly owned family companies. This category of companies is that large in Germany because only very few companies are introduced to the stock exchange or are sold completely. We have analyzed the development of the largest German family businesses in the "generation" between 1971 and 2011: Just 0.5% of these companies were sold per year on average and this trend has been reducing in recent decades. Further, there are very few originally family-owned businesses listed on the stock exchange. (More common is companies which were originally public listed companies in which an individual or a family acquires a significant participation. Thus, this public company becomes by definition a family-owned business. This is a different story than a business founded by an entrepreneur.) By screening the reasons why—nevertheless—some family businesses are sold, we try to get a better understanding of why the vast majority does not consider such an exit route.

Firstly, the largest category is made up of those companies in which one of the owners terminates their participation. In the second, third, and fourth generations, there can be conflicts that destroy the cohesion among the family. If shareholders with a significant participation—say more than 30% of the equity—liquidate their participation it can be very difficult to finance such an exit. Such financing requires that the remaining shareholders put up their own shareholding (or the whole company) as collateral. Assuming that the remaining owners have 70% of the equity and use that fully as collateral, they can raise conservatively a long-term financing to the value of 50% of the shares they hold. That means they could finance the exit of 35% of shares at the most. It might be difficult to get such loans on top of the credits needed for running the business. In order to compensate for the drain and also to free up the collateral, an equity increase is needed and this is financed by an IPO.

For some decades in the past, the second reason for going public was to raise the money for inheritance tax. In Germany, this is some 30% of the value of the equity. Only if the owners had structured the step-by-step-transfer of the share in time, could they possibly absorb the financial burden. If not, the sudden cash requirement could lead to a financial bottleneck which only an IPO could remedy. (The very high inheritance taxes in the USA, UK, and France have been the major reason for the demise or even destruction of the population of wholly owned family businesses in these countries.) In the last decades, a relief of the inheritance tax was granted by the German Government. Therefore, this reason was not relevant anymore. It might become a necessary vehicle again as the inheritance tax is reactivated in Germany.

The third reason for going public is to diversify the investment. The concentration of wealth in one company is an enormous risk for the owners. Most family businesses try to diversify their activities within their company as they grow older. Therefore, Haniel or Oetker—our old family businesses—are broadly diversified enterprises. Some businesses stick to one industry—such as the software company SAP. Through the IPO, the founders could partially liquidate their shareholding and diversify their wealth.

The fourth reason for going public was significant in the past but does not seem to be relevant anymore. Thirty years ago, the banks promoted the idea of going public with minority shares as a modern trend for family businesses. The argument was that by keeping the majority of shares, the family owners could run the company as they used to when they were the sole owners. The reality was more difficult. The financial markets are highly regulated. The shareholders have rights today. In order to meet shareholders' expectations, the listed family companies had to increase their profit distribution quota beyond the moderate disbursements they used to have for the family only. As a majority owner, the family members are always insiders. As insiders, they could not easily liquidate some shares as the markets considered that to be a warning signal for upcoming price deteriorations. Today hardly anyone would follow such a promotion campaign for IPOs anymore.

A fifth—completely different—reason for an equity increase is the strategy to cooperate with a larger company and comply with the request of the cooperation partner to strengthen the cooperation by a participation of the larger company in the family business. Most of these cooperation projects turned into sad stories of

continued frustration on the side of the family business. As a result of the participation of the larger company (such as Siemens), the family owners lost their independence. The cooperation did not generate the expected synergies. We have a list of 18 German companies with such cooperation projects. All these cooperations have been dissolved in the meantime. It was always the family partner which terminated the contract and bought back the share, in order to regain its independence. In this context, it is worthwhile to note that there is hardly an example of a merger of two-family companies. This is quite a contrast to the often-practiced concept of a merger between equals or almost equals among the public companies. In the case of family companies, even two owner groups would sacrifice their independence. Before considering such an option, apparently, one owner group would rather sell their company.

Also, the sixth reason for selling the company is often frustrating in hindsight. These are the cases where the sales were triggered by a seemingly very attractive offer. A large international company was just willing to pay an extraordinary premium to get access to the German market. The owners considered this a unique opportunity. Looking closer at these cases the attractive offer was just the tipping point in a sequence of factors leading to the sale of the company. There might already have been tensions between the two-family tribes. Or there was the hope of having a capable successor among the descendants and this hope was not fulfilled. Or the company missed a technological innovation and could not finance the catch-up race. Without these weakening influences, the lure of the attractive offer would perhaps not have been accepted. One of our studies analyzed seven such cases. In none of these cases was the family able to reinvest the cash received successfully. They could not find direct investment opportunities which were as rewarding as continuing their successful wholly owned business. Anyway, they could not invest at "book value" as they had been able to do in their family company. They had to acquire attractive investments at market prices which were three or more times book value. However, there are a few cases reported where this was possible. Obviously, only very few industrialists have the talent of being an extraordinary financial investor. Warren Buffet is so renowned because his talent is that rare.

Now come the earnest cases in mature markets where a whole industry is shrinking and only very few companies will survive. Approaching this endgame there is the choice between just two strategies as Kathryn Rudie Harrigan describes in her research "Strategies for Declining Businesses," 1980: Acquiring other companies or selling to the market leaders as long as they are still interested in acquiring other competitors. These scenarios are not relevant for dynamic, developing markets such as China—yet.

With this list, we may conclude the review of the reasons for partial or full sales of a family business. We should not conclude without a comment on another modern trend. Today the conditions for start-up financing are a valid reason to go public. If someone starts a business without any of their own capital, just with a good business idea, he or she needs third-party financing right from the beginning. These start-up businesses are fundamentally designed to go public or to be sold to Private Equity. These are not family businesses from the beginning with a "dynastic intent."

Recently, one of the smart start-up entrepreneurs explained his history and future umbrella strategy. He did his first start-up project to learn the trade. This was a flop. Then he started—without any capital again—the second one which is a success. But, after some financing rounds, he owns just a small portion which will be sold soon. But then with the money from the prospective sale of the second one, he will start the real important project. This he will own as his family business. A real modern entrepreneur: Trying to make some money by start-ups first, to be able to found the family business which he will develop for his family.

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Profit Distribution Policy in Family Enterprises

Hermut Kormann

1 The Relevance

The calibration of the dividend policy is an issue in almost all family-owned businesses. Perhaps less so in the first generation, but more so in the second or subsequent generation. The challenge is to find reasons for distributing profits at all and if so, to define the extent of this generosity. In this endeavor, the interests of all stakeholders have to be taken into account.

It is difficult to talk about financial needs and available money even among family members. Profit distribution sounds somehow "negative", kind of wasting something valuable. Whereas retaining profits sounds like a highly disciplined virtue.

However, talking about the financial requirements of the family members in time is essential in order to avoid a potential mismatch of expectations later on.

Whenever one tries to get a picture of the practice of dividend distributions, one will find out that a quantitative analysis asking for the percentage of dividend of total profit is not sufficient to delineate a prevailing policy. The dividend in the first generation has to be lower in order to finance the higher growth rate during the first generation.[1] This is acceptable for the founding owner as he or she receives an income as managing director anyway—plus a pension entitlement. In qualitative interviews and by collecting examples of prevailing practice among the participants in workshops, one seldom gets a strategic explanation of the practice or one hears statements such as:

[1]See Seibold et al. (2019) on the higher growth rates during the first generation.

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- “We distribute all the profit.” (There are business models in which this is even possible.)
- “We take out what we need.”
- “We have had our standards for decades, which we adjust from time to time.”

In a survey during the Family Business Network Conference 2018, about 37% of the participating companies said that they have a dividend per share, which is variable based on the company performance, and another 26% have a certain percentage of the net income of the company. About 30% do not have a policy, the majority of those companies without a policy feel that they need one. One of the essential elements—not the only one—is the overall portion of the profits paid out.

Summing up all information we have on German Family companies, the span of profit distribution in the majority of family enterprises in the form of limited companies is in a range between 15% and 30% of the after-tax profits. But we will illustrate in the following reflections that even such averages are not a sufficient guideline. There are better and more specific benchmarks available for orientation.

Orientation is needed to reconcile diverging interests between various stakeholder groups:

- Interests of the owners versus the interests of the enterprise.
- Interests of the active generation and the next generation.
- Interests of the owners and other stakeholders such as banks or bondholders.

Our understanding is that distributing profits from the family business to the family is an important connection between both institutions and strengthens the cohesion. But in order to develop this cohesive function, there has to be agreement on the ways and means of transferring financial funds from the business to the family. Thus, we believe that rules are essential to make profit distribution into a positive element for both the sender and the receiver. In view of the broad span of practice in distributing profits, it is essential to understand the reasons for arriving at a specific percentage. The logic for defining the amounts to be distributed or retained can be:

- Oriented to the requirements of the shareholders primarily.
- Oriented to the requirements of the business primarily.
- Balanced between the requirements of both the owners and the business.

2 Distributable Return of Financial Investments

Before developing general maxims, one has to gain a perspective on the big picture: The big picture shows that the fundamental value, which is reflected for example in the sales value of the assets, is the dominating feature of wealth—not the annual profit distribution.

Let us assume that the investment in nominal financial instruments generates a nominal return of 7% which is taxable. Now, one has to deduct from this gross return many items: Income Tax, administration cost, reserve for compensating the effect of inflation, in Germany also inheritance tax. After deducting all those items, the final balance is only between 1.5 and 2% of the value of the investment, which can be distributed. Even if all the wealth is invested in shares, the Dividend Yield is also plus/minus 2% on the share price, less taxes, less administration cost of about 1% and so on.

This model calculation demonstrates that the sales value of the asset is at least 50 times or even 70 times higher than the current annual cash benefit.

Why does the average owner not sell? Because he or she anticipates an increase of the underlying fundamental value of 4–7% annually, that is 3 or 5 times as valuable as the dividend. Just to add to this finding of how negligible the dividend is, comes the theory on dividends in general. The logic is laid out by Messrs. M. Miller and F. Modigliani. They tell us that the dividend distribution is irrelevant for the wealth of the shareholder. Each Dollar distributed reduces the value of the company but increases the value of the shareholder's bank account (leaving aside any tax effect). Thus, the aggregate amount remains the same. This is of course correct. Only; it cannot be spent by the individual shareholder unlike the dollar in the bank account. To corroborate, there are even public companies that do not distribute any dividends at all. The complete retained profits lead to an increase in share value only. Whenever the shareholder wants to convert this value increase into cash inflow, he or she needs to sell a respective quantity of shares.

This is now the decisive difference between shareholders of public companies and the owners of (privately held) family companies: The latter cannot sell shares easily. Therefore, the annual dividend is essential for providing a personal financial benefit for the owner.

In addition, most family owners can expect—from time to time, but at least once in one generation—a so-called "Liquidity Event." This is the distribution of extraordinary cash flow in an extraordinary distribution to the shareholders. Typically, such a Liquidity Event allows the individual shareholder to settle his or her financial obligations or enables them to invest in their personal wealth, e.g., building a family home or financing retirement.

3 Impact Factors on Distribution Policy

There are two completely unrelated attractors:

- Retaining profits in the interest of the company.
- Distributing dividends in the interest of the owners.

Retained profits in the company can:

- Either increase the financial stability by reducing debt.

- Or be invested into the growth of the enterprise.

The other side of the scale, the cash pool of the owners, is by far more complicated.

The major elements determining the necessary distribution:

- Cost, specifically the taxes of ownership.
- Cost of transfer of ownership to the next generation.
- Amounts required for consumption; and there are at least two generations who want to have a budget for consumption.

Let us return to the needs of the company, the source of the cash flow for the distribution.

Thus, the needs of the owners form a fairly complex financial pattern. Retaining profits for improving the financial stability is all the more necessary if the indebtedness of the company is fairly high. Or from the other side: If the company has an excess cash position one could hardly argue for profit retention.

However, the more demanding influence on the retention of profits is the growth ratio of the company. By and large, there are the following financial consequences of a growth trend:

- Sales growth will lead to a somewhat proportionally higher growth in total assets.
- The growth in total assets requires an equivalent growth rate in equity through retained earnings.

A real sales growth of 10% would require retained profits of 2.7% on sales for financing the increase in equity. This again would necessitate an EBIT ratio on sales between 8% and 10%. That is well within the realms of possibility. However, where the growth rate is higher than that, an EBIT ratio well above 10% would be required. Only very few companies are likely to achieve such extraordinary profitability.

When developing specific guidelines, one encounters the question of whether such growth is needed at all. Well, as the whole economy has been growing and will continue to grow, stagnation of a single enterprise would mean a comparative shrinking. Reducing the size is not a reasonable proposition. Anyway, family enterprises achieve on average higher growth rates than public companies.

In summary: The required growth rates are achievable with normal rates of return, but it requires in addition a moderate distribution policy. Increasing the distribution rate from 20% to 25% will be equivalent to a reduction of the annual growth rate by 1%. The increase from 20% to 30% will even reduce the growth rate by 2%. Does this really make a difference? It does, indeed! 100 years growing by 6% p. a. will give a company some three billion EUR sales. Growing by 4% p. a. will lead to a company of just a third of that size.

4 Summary: Simple Rules as a Guideline

There are two concepts of simple rules on Dividend Policy in a Family Business that combine the requirements of the enterprise for securing its future with the requirements of the family for current consumption:

1. The first is the aspect of available funds (Pecking Order Theory).
   100% equity and no debt, or even high liquidity, would allow 100% distribution of profit.
   0% equity allows 0% distribution.
   30% equity on sales (it works with the ratio of Equity on Assets, too) allows 30% distribution quota.
2. The second heuristic starts out with the growth target or the growth need and compares this target with the average profitability (net-profit on equity). To the extent, the actual profitability exceeds the growth target the excess profit can be paid out to the shareholders.
3. The third concept is the concept of intergenerational fairness.
   The consideration of fairness would require that the current generation sets aside such savings amounts that the next generation would inherit the same wealth as the parents had inherited themselves. If the second generation sets aside double the amount of their own consumption as savings for the next generation, then this would meet that criterion of fairness for two children. A distribution quota of one-third reflects such a 1–2 ratio of consumption and savings. If the relation is 1–3, the next generation would enjoy an even larger starting base than the parents themselves received. Thus, the distribution could reinforce the cohesion of the family to the family business and the retained profits secure the longevity of the company as an independent, financially stable Family-Owned Business.

   This is what we consider to be the overriding objective: Securing the longevity.

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Part III

The Development of Professional Owners and Capable Executives in Family Enterprises

Developing Responsible Owners in Family Business

Joseph H. Astrachan and Torsten M. Pieper

1 The Relevance

Successors in a family business must often come from the ownership group and the more responsible and better trained the pool of potential successors, the better the selection will be. Responsible owners will value the family business and the family group over individual interests and support those solutions and successors selections that are most conducive to the long-term survival of the family business.

Responsible owners have the ability to ask critical questions and hold the firm's management and leadership accountable for their decisions and actions. Entirely delegating this crucial task to a third party (e.g., the board of directors) or—in the worst case—neglecting it entirely may create the danger of relinquishing control over the business and increasing the distance of the family owners to the business.

Despite its importance, relatively little research has been done on how to cultivate responsible owners in the family business. The purpose of this chapter is to help fill this gap. Toward this aim, we present strategies for developing responsible owners highlighting educational age-specific milestones, the role of self-esteem, shared values and family culture, and specific training methods.

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2 The Responsibilities and Professionalism of Family Shareholders

2.1 Educational Milestones

Education is an important component in developing responsible owners (Astrachan et al. 2020).

The following table presents a list of age-specific tasks and the appropriate age ranges for these tasks. Each item is discussed in more detail in the following sections. While each task is represented separately, it is important to keep in mind that the various educational milestones should be integrated into an overall, whole-person learning approach (Barbera et al. 2015; Bernhard et al. 2020).

Age-specific tasks	Appropriate age (years)
Actions–consequences link	3–5
Money	5–8
Trade	6–9
Importance of future (no instant gratification)	6–11
Investing	9–12
Separation of ownership and management	10–15
Emotional differentiation	18–25
Balance sheet, P&L, Cash flows	18–30
Financial analysis (CAPM, DuPont, EVA)	24–35

Actions–consequences link refers to the fact that actions have consequences and that individuals should be knowledgeable about this link. As mentioned earlier, a crucial role of owners is to hold the management and leadership of the company accountable for their actions. In order to do so, owners must have a sense of responsibility themselves. Otherwise, they risk holding managers accountable to standards different from their own, which leaves room for ambiguity and creates uncertainty, both of which render accountability less effective. Ages 3–5 represent the appropriate age range for instilling the actions–consequences link because this is the developmental stage where children start recognizing their own limits and are able to make choices between two things. The crucial component in developing this link is that parents should establish clear, consistent criteria through words and actions. So, when a child engages in a certain behavior, both parents will respond in the same manner—independent of what the child does.

The meaning and use of money is another important milestone in developing responsible owners. Money is a crucial element in business. It is important to begin teaching children at a young age, typically between the ages of 5 and 8, the value and use of money. It is crucial that children learn that money is not just coins and paper but represents the value of things. For example, children need to understand that some things are taken away from them in exchange for receiving other things. Understanding the need to give up some things in order to acquire others will allow them to appreciate the true value of things. Their understanding of money's

role and the spending and saving habits they develop early in life will shape their attitudes toward a wide array of financial matters in adulthood and impact their roles as responsible business owners.

Trade is related to, and therefore partially overlaps with, teaching the value and use of money between the ages of 6 and 9. Children who develop a good understanding of the motivations and underlying procedures of trade can bank on this understanding later in life, especially in a family business setting where trade is an inherent element of business procedures. Trade also emphasizes reciprocity, which is crucial for being a good owner. Reciprocity means that when you make a trade, it should be a fair trade; otherwise, one party gets disadvantaged to the benefit of the other which most often will have negative consequences for the partnership in the long run.

In learning about money and trade, it is important to stress the value of future when children are aged 6–11. A crucial component is the maxim that there is no instant gratification. Research shows that children who are able to delay gratification and wait in order to obtain something they want are better adjusted psychologically and more dependable as individuals in later life (Stanford Marshmallow Experiment). Delaying gratification with its many positive outcomes is a desirable trait in business life later on where the reward is often a function of endurance, perseverance, and patience. Parents can develop the acceptance of delayed gratification in their children by making them wait to get what they want. Obviously, the amount of delay is contingent upon the type of desire, the child's age, and other factors.

Once a child is aware of money and other financial tools, learning about investing, ages 9–12, is the next important milestone in educating responsible owners. It is important to stress that knowing the importance of the future is a crucial condition for understanding and making investment decisions; this is especially true in a family business context, where long-term wealth creation is often more important than short-term profit maximization. Investing involves learning about risk and reward (therefore the need to delay gratification to have higher rewards in the long run), and understanding types of investments (e.g., stocks, bonds, securities). Having children select a stock to invest in, visiting that company and using its products helps them understand elements of ownership.

Separation of ownership and management should be taught when children are 10–15 years of age. The key to this milestone is the understanding and acceptance that ownership does not automatically make one a manager. The different roles need to be defined clearly and the requirements for each function need to be explained and commonly accepted. This will prevent feelings of entitlement and wrong expectations from causing conflict in both the family and the business realms.

Emotional differentiation is a critical developmental milestone between the ages of 18 and 25. Put simply, emotional differentiation is when the emotions of others do not cause an inappropriate emotional reaction in oneself. A good example is a mother who suddenly comes crying into the room where the family is having a serious discussion about the business and without a word having been said, everyone falls apart without knowing or asking why or what she is upset about. The mother's emotions have caused an emotional reaction in the other family members. Achieving

emotional differentiation is a difficult task and requires hard, consistent work. In addition, since no two individuals are the same, each requires a different path.

Learning and understanding how to read a balance sheet, profit and loss accounts, and cash flows are important milestones at ages 18–30. Owners who have this ability can interpret the financial and business information provided to them and gain a better understanding of the situation at hand. This is especially important for owners who do not have a business education and are less familiar with these matters. Understanding relevant business information will allow owners to ask the right questions and hold management accountable for their decisions and actions.

Finally, financial analyses—such as Capital Asset Pricing Model, DuPont Model, and Economic Value Added—are important developmental milestones to be taught in the age range 24–35. The capability to assess the viability, stability, and profitability of a business, business unit, or project is important in deciding whether or not to maintain an investment. Specifically, it provides information about whether to maintain or discontinue an operation or business unit, whether to make or buy materials necessary for the production process, or whether to use debt or equity to invest, to mention but a few critical business decisions. Knowing about and being able to process these decisions themselves allows family members to think more critically and to make better-informed decisions for their businesses, and for their personal wealth and that of following generations.

While the above educational milestones focus on the individual, another crucial element, especially among siblings but also other family members, is to force them to make decisions together. Joint decision-making not only helps build a routine for working together but—paired with self-esteem—it also establishes trust.

2.2 Developing Self-Esteem

The previous discussion has largely revolved around teaching family business owners financial skills. But it is also important to mention that developing responsible owners should put equal emphasis on developing self-esteem in individuals. Self-esteem, an individual's evaluation of his or her own worth, is important because individuals with a healthy level of self-esteem trust their own judgment and feel secure enough to express their thoughts, and are sensitive to the needs and feelings of others.

Self-esteem can be developed in the following ways:

- Consistency in childhood: This is the most important of all the tactics described here. Parents should not respond differently to the same behavior. Coherence of words and actions is important in raising children. It allows children to anticipate the consequences of their behavior and thereby helps enforce guidelines for behavior.
- Actions and consequences are connected: Realizing that actions and consequences are connected to one another allows children to trust their judgment and develop their sense of self-esteem.

- Sense of control over self: Having a sense of control over oneself gives individuals the confidence to act independently and also to support others in need.
- Mastery of tasks: Mastering tasks is important because it gives a sense of accomplishment and pride. It is important that children master their assigned tasks by themselves and make mistakes in order to learn and improve for the future. Recovering from mistakes is essential to self-esteem.
- Accurate feedback: Parents should not over-praise their children when they perform below what was expected. But at the same time, they should also not spare their praise when their children perform above the expected. Accurate feedback is necessary because it instills confidence and reflects consistency. It communicates that parents trust their children by telling them the truth.
- Familial support: Familial support is important because it shows the individual is not alone but has a support system on which to rely. The presence of such a safety net gives confidence to encounter and deal with failures and difficulties.
- Being listened to: Knowing one is heard shows that others care and are there to listen to concerns and eventual problems. Ultimately, it shows individuals that they are valued. Knowing that others are there to listen provides a sense of security that individuals with self-esteem can then render to others.

So far, we have talked about educational milestones and self-esteem as important building blocks for developing responsible owners. These measures should be tightly integrated into a set of shared values and the specific family culture. We look at these aspects in some more detail in the following section.

2.3 Shared Values and Family Culture

Shared values represent the fundamental beliefs and principles that constitute the culture of groups or organizations and guide the decisions and behavior of their members. A set of shared values is in many ways a set of guidelines or intents, commonly accepted and internalized by the members of the group or organization. For example, if one of the family values is "*we do not lie*," family members and, by extension, employees in the business know that lying is unacceptable.

Families are "primary groups" that socialize their members from an early age and form the basis for an individual's ideals. Early socialization provides families—unlike other groups—with the advantage of being able to instill shared norms, beliefs, and values in their members over an extended period of time. Therefore, it is important for a family to determine what its values are and to reiterate these values consistently and on multiple occasions.

Values determining what goals the family wants to achieve and how it wants to achieve these goals help regulate individual behavior. Values also help individuals understand the boundaries of appropriate behavior; that is to say that the strength of and common agreement on values help family members know what behaviors are acceptable or unacceptable. In this respect, shared values help coordinate and

synchronize the actions of family business owners and help build cohesion in the family and ownership group (Astrachan and Pieper 2008; Pieper 2007).

A set of shared values and the early internalization of such values may also help to harmonize the preferences and choices of family owners, thereby reducing potential ambiguity and conflict. This is especially important when the ownership group has grown large and preferences can no longer be assumed to be equal. Shared values also communicate to in-laws who marry into the family what is important to the group and further help reduce potential ambiguity and conflict.

Given their crucial role in guiding behavior and coordinating actions, shared values of the ownership group should also be integrated into the organization via its culture. A culture based on stewardship seems conducive to developing shared values and therefore appears particularly suitable to family businesses. Stewardship stems from medieval times when a "steward" was assigned to prepare the young prince for his future reign and, ultimately, make him a successful king. The meaning has not changed much nowadays. Individuals with a stewardship mentality are good team players who do what is in the best long-term interest of the group or organization to which they belong. A stewardship culture is one that nurtures and facilitates responsible, pro-organizational, and trustworthy behavior among individuals.

Stewardship works best where individuals are intrinsically motivated and identify with the group or organization to which they belong. These conditions are commonly found in business families with high levels of cohesion (i.e., where the members are close to one another) and capable of transferring this closeness to their managers, employees, and other stakeholders. Stewardship is commonly associated with long-term wealth creation rather than short-term profit maximization. Strong indicators of a stewardship culture among family businesses are statements like "*We want to build a business that will last for generations and contribute to the greater benefit of society*" or "*Our goal is to pass this business along to the next generation in a better condition than it was given to us*."

As we have seen earlier, developing responsible owners should begin in early childhood. Educational milestones, development of self-esteem, internalization of family values, and developing a stewardship mentality are attitudes that should form part of early upbringing. It includes educating family members to build a consciousness of self and others, and to understand money and other tangible assets, thus preparing the ground for becoming responsible owners. Following childhood, there are further specific training measures that can be taken to prepare the next generation for their ownership role. We will turn to these measures in the following section.

2.4 Specific Training

Before we discuss the various specific training measures to develop responsible owners, it is important to reiterate that whatever programs a family business puts in place to develop responsible owners must fit that specific family business's culture and aim to reinforce cohesion in the ownership and family group; our research shows

that cohesion is a crucial element for securing the long-term survival of the family business.

When ready, next-generation members should attend family meetings and shareholder assemblies where they become familiar with extended family, thus increasing their identification with and sense of belonging to the larger family group. As adolescents, next-generation members are further sensitized to the fact that the business represents an important emotional asset, which increases their attachment to the family business. Professional training—such as seminars on financial management—and regular meetings around the business allow next-generation members to apply their emergent financial skills in a business realm and help strengthen their identification with the family business and the ties among next-generation members. These activities also help reiterate and internalize core values of the extended family and thus increase bonding to the family and business.

Plant tours and internships provide additional opportunities for developing responsible owners in that they help build a deeper knowledge about the business and allow individuals to identify with the business, its employees, and products. Getting to know first-hand what the business does and meet the employees instills a sense of responsibility for the family business legacy.

Apart from formalized training opportunities, learning from good models is another opportunity for developing responsible shareholders. Good models can be family members, but also non-family members, individuals who live the values and display the kind of responsibility for which the family strives. It is often advisable for families to visit with other families in business that they respect and consider to be doing a first-rate job in managing both the family and the business. Such visits provide opportunities to exchange and learn from others to improve one's own skills.

3 Conclusion

Our key suggestions for developing responsible owners in family business can be summarized as follows:

- Develop a business sense in childhood: The earlier business sense is developed, the sooner children adopt a mindset that is compliant with the family business. The various educational milestones discussed earlier are all geared toward building this foundation. They should be supplemented by developing self-esteem in individuals.
- Learn to work and make decisions together: A crucial element—especially among siblings, but also other family members—is to force them to make decisions together. Making decisions together not only helps build a routine for working together but—paired with self-esteem—also establishes trust.
- Accept delayed gratification: As mentioned earlier, the ability to delay gratification in early childhood comes with many benefits in later life. This trait will be of special importance when making financial, investment and business decisions for

the family business, since sacrificing short-term gains for long-term value creation typically facilitates survival in the long run.

- Integrate good values, morals, and ethics: Good values, morals, and ethics are the glue that cements everything the family does to develop responsible owners. It does not really matter what these values are, as long as most (ideally all) members of the family and the business agree to and share them. When values are shared by everyone, they provide guidelines for behavior, they communicate expectations, and they harmonize preferences, which together ultimately increase the cohesion of the owning family and the business overall (Astrachan and McMillan 2003).
- Understand stewardship: A stewardship culture seems most appropriate for long-term family business survival. Stewardship instills a sense that serving the business is a more important responsibility than serving particular individual interests (see also Le Breton-Miller & Miller 2015).
- Attend family meetings: Attending family meetings allows for good communication and the development of strong relationships. When the family has grown large, regular meetings allow the establishment of relationships and bonding with the extended family.

Finally, we encourage parents not to shield their children from knowledge, good or bad. Children should be given exposure to a broad array of knowledge to make them well-versed and responsible future owners of the family business.

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Development of Executives in Family Enterprises

Birgit Suberg

1 The Relevance

Executive development is a key task for ensuring an organization's future. In family businesses, we sometimes see that the major topic of CEO-succession planning overshadows the issue of developing future executives in general throughout the organization. But no matter if the business is led by one sole leader alone or—as is becoming more and more common—by a team of leaders, all key positions require continuous attention. Regularly reviewing the organization chart, discussing crucial roles, as well as identifying and developing key talent are of utmost importance.

Basically, planning the succession for any management position should be a normal procedure in any type of company or even organization. In the family business, however, this normal requirement develops specific characteristics. One of the peculiar features of family businesses is the long tenure of the family CEO as well as other home-grown executives. This implies that the elapsed time between major succession moves is longer, the practice in the procedure might, therefore, be less developed than in larger companies. Therefore, the lead time for advance planning should be longer in order to make a good job of this rare task. Taking everything together, the succession planning is a more demanding and more important "homework" in a family business. Just consider the lone founder who transfers his or her role as CEO to a successor (no matter if that is a family- or non-family manager). And the only change is that change in the CEO position. The management team that the new leader has to lead and integrate into is exclusively composed of the "old guard" selected by the founder, with similar experiences, training, and age. Then the task of second-level succession planning and executive development is left to the newcomer. Such a situation can be very challenging for all concerned.

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Many successful family businesses put a lot of thinking and effort into designing the transitions, the "phasing-in" and "phasing-out" of key position holders. They convey a special attention to timing and team composition in order to ensure that the capabilities of the top management as a whole match the future strategic requirements.

2 The Elements of a Comprehensive Succession Plan

2.1 Planning Scenarios

Succession planning essentially means planning for four distinct scenarios: In the first place is the obvious succession scenario: the retirement of a position holder. For which exact date is this planned? In the event that this question is properly answered, the second issue is to prepare for an unplanned succession need. This might arise due to the positive event that the current position holder is promoted to another position or it might come out of the necessity that the position holder cannot continue to work. For this, we need an emergency plan. Now, both scenarios cover the needs of the current organization which can be fairly well defined. In addition comes a further planning scenario, mainly the growth of the enterprise. A growth rate of 7% leads to a doubling of the sales every decade. For an enterprise of twice the size as today, one needs between 60% and 70% more executive positions. And it may well take one decade to develop those leaders. Thus, one needs to start today in order to have the experienced executive ready within a decade. Finally—and this is the most complicated element—one needs to design a development path for talented young executives. This implies moving them through a sequence of assignments in order to facilitate their growth in experience and personality. Let us have a closer look at some of the requirements in this manifold task.

2.2 Defining and Anticipating the Need to Fill Key Positions (Pull Principle)

The first three of the above-mentioned scenarios have in common that the requirements of the organization define the need for succession planning. The first exercise is to look at the current management team as it functions today. One puts on "what if?" glasses and considers one by one the consequences of each position becoming vacated at the standard retirement age of the holder or the position being suddenly deserted for whatever reason. For the planned retirement date, one can prepare a successor with sufficient lead time. In the case of a sudden need for replacement, one typically needs a different person as a successor. There is no lead time for preparing the person. Typically, the emergency alternative is a mature manager, even one who is close to retirement themselves, but with the capability to step into the breach. The task to be solved is clear: The requirements of the position are known. The question is if they can be fulfilled by the candidates. How big is the

distance between this leader and the talents below him or her? Would some or one of them meet fully or at least partially the requirements? And then—most important—the question remains: Which of the currently performed roles cannot be assumed by the intended succession? This question is especially relevant for first-generation or small family businesses where key executives fulfill a multitude of roles. Due to the needs of the company, and due to the existing combination of skills and personalities, unique roles and responsibilities have evolved. Sometimes it is useful at least to consider splitting up a role that has become very large, allowing for the fact that one existing "mold" might need more persons to fill it in the future.

The second and fully complementary inspection is that of the organization chart of the company. That means looking at the design of the organization. This is a very strategic discussion as it includes the question: what are the capabilities we will need for winning in the future? In this discussion, the focus is on future needs and possibilities. Thus, depending on the business strategy, this clearly implies the development or acquisition of skills and mindsets that are wished for but currently not present in the organization. Typical examples for such new key positions and expertise are: international business development or digital marketing.

The first task for the existing leadership is of course to acquire for themselves the necessary skills required for identifying, understanding, leading, and integrating such new talent. This type of expertise has to be hired from the outside.

After having discussed the "demand-side" of key positions, we turn now to the "supply-side" of executive development.

2.3 Identifying Candidates and Their Development Needs (Push Principle)

In general, family businesses are known for a preference to promote internally. If that is the case, taking care of their own "pipeline" of top managers becomes all the more important. That starts with identifying the development needs of high potential future leaders. This requires perhaps promotion of the young talent to new positions (Push Principle) even if there is no urgent pull-requirement from the side of the organization. Whereas large public companies turn to third-party service providers, such as Korn and Ferry or Hays to help them assess talent in a systematic process, most family businesses keep this assessment work to themselves. But they make sure that top talents are discussed specifically and regularly, in the executive meetings, as well as in the board meetings. In the latter, very often, the independent board directors with industry experience are consulted for their opinion and advice. The target of the discussion is to assess "readiness" for the next position, potential gaps, and possible measures for development. At this level, the "gaps" are not so much about specific skills anymore (which the high potential is supposed to have acquired and proven already) but center very much around the following three questions:

- Is the person business and management savvy?
- Does the person have the necessary "soft skills"?

- Can we see a culture fit, including loyalty, to the organization?

For high potentials, the ideal is to accumulate a variety of experiences. For large companies we conceive a threefold experience-ladder:

- Two products
- Two functions
- Two countries

This leads to a development path of about one decade, e.g., a 3- to 4-year assignment each in positions such as Commercial Function for Product A, Technical Function for Product B, Commercial Function in Foreign Country.

When identifying the "gaps" all of us must be aware of the possibility of making a very human cognitive mistake: we often tend to compare a potential future leader with the person that has occupied that position for many years already. We literally compare the seasoned, gray-haired, and jovial 60-year-old sales director for example with the 35-year-old aspiring newcomer for the same position—and find the newcomer too "light" or too "thin." We might perceive a gap of confidence, executive presence, and maybe "personality" in general. We need to remind ourselves that 20 years ago the incumbent himself was much different from today, he has developed himself through the experience.

That is also why, in addition to looking at the "gaps," it is so important to look at the candidate's motivation as well. Where are the interests of this person? How do they match with the position we are considering? What are the expectations? In addition, does the high potential show the required ambition, grit, and the will to self-develop? Because these three are what will support him or her in turning experiences into savvy. The current line manager of this candidate will be able to gain insights about these expectations, attitude, and strengths best through observation of the candidate in the daily work as well as through regular one-on-one dialog.

The time spent on the high potentials is time well spent, it is a very worthwhile task to help a competent person to become an excellent performer. We will turn now to the work of developing identified executives. Doing this, we must keep in mind that development requires motivation and is as much an "inside job" as it can be supported from the outside: the individual has to take responsibility for his or her education, development, and career.

2.4 Developing Future Executives

Managers learn through training and experience as well as through feedback and self-reflection. As mentioned, over time, the higher up the executive moves, the less development becomes about specific skills training anymore. Experience and reflection become the major learning drivers. That is why in some organizations, it becomes obvious that the label of "high-potential" has a "shelf-life." A high level of capability deteriorates if not applied, challenged, and stretched through the

real-life experience of new responsibilities. Of course, there is also the risk that the talented manager gets bored and seeks challenges in another company.

That is why a lot of effort is put into planning and designing appropriate next step experiences for the candidates. A rule of thumb for customizing such a new assignment may be: “highly challenging, but not completely impossible to succeed.” If the development of the executive is one goal, then it is the task of the leader to ensure that the new job is on the one hand complex and highly demanding, and on the other hand offers an appropriate chance for successful fulfillment—not a mission impossible.

A typical assignment which companies reserve for developing their executives is for example to let them establish and head a new subsidiary abroad. Another possible area to look for such challenges is in project management: cross-functional, highly visible new projects, or pilot endeavors.

We have observed that the behavior of the candidate’s line manager plays a very important role in the success of such experiments, especially at the beginning. The leader needs to observe well and find a good balance between staying hands-off and letting the newcomer fend autonomously for him or herself on the one hand and ensuring the minimum conditions for success on the other hand. That might imply a public endorsement at the start, showing confidence in this choice to the new peers and employees of the newcomer who might themselves have hoped their higher seniority would make them more eligible for the job. That also may mean starting the new manager off with a realistic and clarifying dialog about expectations, resources, and boundaries.

There is an interesting concept in the area of education called “proximity zone” developed by the psychologist Lev Vygotsky. It designates the area between what a learner can do without help and what they are not able to do (yet), see below. In the proximity zone, the learner is guided or just enabled by the presence of a more experienced leader or peers who provide suggestions or just function as thinking partners in a regular dialog. Vygotsky defines this zone as the area where advanced learning is most encouraged and ensured.

It pays off if the leader remains “within proximity” and available to a certain extent for such dialog. Of course, an internal mentor or an external coach can provide additional support.

Such conversations also encourage processing and self-reflection, the big executive learning driver as mentioned above. Through receiving feedback and making sense of their challenges, executives are able to accelerate their own learning and to turn experience into internalized knowledge.

3 Summary

Executive development goes far beyond preparing the succession at the very top. It is an ongoing joint investment in the future of the company as well as of the executive that is—if it goes well—mutually rewarding for the long term. It is top management time, attention, and effort very well spent.

The top management team itself has to perform this task for the upper echelons of the organization. In doing this, the top executives might identify a development requirement for themselves—and do something to address it.

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Challenges and Benefits of Sibling-Consortium in Management of Family Enterprises

Hermut Kormann and Birgit Suberg

1 The Basic Patterns in Historical Development

When asked to describe how German business owners and their families "organize" the succession, the first comment to be made is: The pattern has been changing over the past two generations significantly. The concepts for the transfer of ownership can only be interpreted against the background of legal regulations and cultural traditions. In the nineteenth century, one standard concept for the transfer of any businesses was: The ownership of the whole company or at least the majority of the shares was transferred to the eldest son as a matter of course. Thereby the business owners copied the will practice of many noble families. The transfer to the eldest son was a common practice among noble families for generations—however only in certain regions in the world, i.e., Northwest Europe and Japan. In these regions the power of the noble families was based on the size and productivity of the farming estates belonging to the area they ruled over. It was necessary to maintain the productivity of the farms by avoiding the split up of the land among many heirs. In other regions, different practices prevailed. In Russia and India, all sons were the heirs of land and business. In the Arabic region, all descendants had to share the assets. Also in the countries which had to assume the law of the French emperor Napoleon (Code Napoleon), it was mandatory that the assets of a family were transferred to all children in equal shares.

In Germany today, there is a common understanding that the selection of one out of two or three children as the sole heir of a business will jeopardize or even destroy the cohesion among the family. This would be considered an uneven and thereby

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unfair allocation of the wealth of the family. In all likelihood, there are not enough non-business-related elements in the total wealth of the family which would allow the value of the company shares given to one heir to be balanced. The increased importance attached to family bonds and the modern understanding of justice and fairness have led to the present standard pattern that all descendants inherit shares in the company.

Nevertheless, many senior owners are often still convinced that the ideal for the management of the enterprise is to have just one "captain" who has the sole power in the management. At the same time, the senior has the natural wish that one of the children differentiates themselves by taking an interest in assuming the succession. Sometimes it is clear that only one child is attracted by this option or qualified for this career. But we have met again and again parents who recognize that two or three of their children are interested and qualified to be engaged in running the family enterprise. This often causes headaches as the parents may be torn between the obligation they feel to treat all children equally and the conviction that one ruler should have the autonomy in the business. Sometimes this conviction is supported by the argument that the shared responsibility of all siblings would increase the risk of conflicts. These conflicts might put at risk the sustainability of the enterprise.

2 The Argument in Favor of a Sibling-Consortium

Based on the findings of family business research and our own experience we can contribute the following arguments to this reflection. First of all, the current and future size of the enterprise has to be taken into account. A business with less than 100 employees does not need two general managers, a business of 1000 employees certainly does. Further, it is basically fortunate for a family and a family business if more than one child is interested and qualified for positions in the company. And we could name many very successful companies under the management of siblings and this very fact of joint leadership is in these cases clearly one of their company's success factors. There are however some principles to be applied in order to make such a shared leadership viable. Of course, these considerations are based on the culture of family and business organizations in Germany. Siblings consider themselves as equals in their role as members of the same family. This constitutional understanding does not allow too much of a hierarchical differentiation of the siblings in their business role. Essentially this means that brother and sister have to form a top management team with basically equal rights. The concept of colleagues is quite usual in the German business system. For example, this form of shared leadership is mandatory for *Aktiengesellschaften*, the legal form for German listed companies. It is however necessary to design the whole governance system carefully in order to fully utilize the advantages and to curb the potential disadvantages of such a concept. As in Germany, a two-tier supervisory structure is common, there is no CEO/chairman-duality and the chairperson has quite an influential role. With respect to the potential risk of disagreements among the top management team, it is essential

that there is a supervisory board with a chairman who is independent of the management. That means typically this is a non-family supervisory board chairman.

In the writing on the issues of the family business, there are many narratives about the dangers of conflicts among family members. From our experience and professional perspective, this risk tends to be overstated. In any team which has a shared responsibility for complex tasks, there is the likelihood, even the need, for differing opinions which might even escalate into conflicts. Any management team experiences that and has routines to manage such a situation. The same can be assumed for committees of shareholders, boards, or professional management teams. Further, we have analyzed to which extend the downfall of family companies—in Germany—can be traced back to conflicts among the shareholders. There are stories of conflicts, of course, but just a small portion of the family companies are destroyed by a conflict. The general reason for the downfall of the family business is inflexibility in the adjustment to changing markets and technologies and deficiencies in the strategy. The critical development of the financials of the company can on the other hand—as a natural consequence—lead to conflicts among the management or the owners. Obviously, critical arguments are even necessary in such a situation. Thus, a good strategy is more important than harmony. Conflict between mature adults who have learned to handle their differences can be very useful, considering different perspectives helps to avoid risk.

Many German sibling-led family businesses show a new practice: while the brothers and sisters may share the same authority in the business, they have split their roles according to interests and capabilities—thus complementing each other. For example, one of them being responsible for the technical and production side, the other for sales and business development. If there is a third or fourth younger brother or sister, very often they might take over the responsibilities of digitalization, development of newly emerging markets, etc. Of course, there are also examples where it did not work out, but those who co-manage their family business successfully tell us about the importance of cultivating trust proactively and continuously. Siblings are not rivals by nature, they say, in the best case they can be friends or partners, who—over a long time—have fine-tuned the successful regulation of conflicts between them.

There are clear indications that several owners who are responsibly engaged, are capable of cooperating and that this will lead to a more sustainable strategy than the visions developed by a sole shareholder with unlimited and unsupervised power.

Preparation for Succession in Family Enterprises

Hermut Kormann

1 The Relevance

The board should naturally be involved in preparing the succession in the leadership of the family-owned enterprise. Either the board is the authorized institution or, in a case where the authority is withheld by the shareholder assembly, could advise this assembly on such an important decision. If a family member is qualified and willing to assume the succession then he or she will have the preference. But then the "how," the preparatory steps, and their timing, still need to be reviewed. To this end, one should reflect on the entirety of competencies a beginner in the profession needs to acquire as an aspiring executive and owner of a family business.

2 Mandatory Requirement: Passion for the Business

The first prerequisite is that the future owner must value "a" business as a fascinating activity. Affinity to business, in general, is important and then specifically to the "own" company. This attitude is developed during the phase of adolescence. If the parents cannot communicate to their children that they love what they do in owning and managing a business, they cannot expect that the children consider this to be a positive option for their life. In the course of upbringing and socialization, the bond between the family members and the business has to be created. Scholars call it "psychological ownership": The conviction that the business is something that is meaningful for an individual's personal life.

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3 Crucial Learnings

For any profession, one has to learn several things which fall into two categories: The general know-how of working in a profession on the one side and the specific know-how of a trade. The general know-how of working is learning to work. For the future executive, this tends to be the world of an administrative organization. In specific industries, such as retailing or selling insurance policies, this working experience also includes these specific basic activities. Then comes learning to "lead." And then comes learning to cope with the "size of an organization" and finally comes the phase of learning to carry "responsibility."

The know-how of the trade is specific, of course, for each industry. This know-how covers the technology of the industry, the specific commercial practices, and legal aspects, and, very importantly, the risks of the business.

4 Learning to Work

The first development objective is to learn how to "work in an administration." The work of an executive is leading other people. Before I am able to lead other employees, I have to learn the work of an employee and develop my capabilities of being a good employee. One does not learn that at school, nor at the university. One learns that only by doing: To arrive at the workplace on time, to get organized, to express requests in a decent and understandable manner, to set realistic dates for work to be completed, to double-check the results of any work, to avoid avoidable mistakes and so on. Now, this normal training at the beginning of any career cannot be gained in the family company. In the family company, the siblings are always the prince and princess of the "King Owner." The staff would shield the potential successors from the problems of the daily work. They would not be allowed to make bloody mistakes—as a prince is not supposed to make mistakes. The best place to learn to work is a large organization. Even if the colleagues know that their new team member is a member of a business family, it would not mean that much in a large organization. The larger the better, to allow for the making of many mistakes and to become acquainted with the difficulties of any organization.

5 Learning to Lead

The next development objective is to learn to "lead." It is fair to say that this is a very critical phase of the early career: How to set objectives, explain them properly, make decisions on open questions or conflicts, follow up the execution, double-check the outcome, correct mistakes of others, have the employee dialog. Also, learning how to delegate and to foster initiative is one of the biggest challenges of any new leader. Finding and being comfortable with the right level of tolerance for mistakes, or, as the late James March calls it, building one's own appropriate "attention buffers" to overlook small imperfections in order to encourage autonomous problem-solving. A

young group leader or department head has a lot to learn in order to develop leadership competency. Inevitably this is initially not perfect. Also, the young leader will make mistakes. Obviously, it is also important to learn these first steps of leadership in a "foreign" organization, a company where one is just a normal employee on his or her first steps in their career.

6 Learning "Size"

The third development phase is learning what the "size" of a business organization entails. This is an important aspect, because the founder did not realize that this requires a specific learning program. He started from small beginnings and developed the organization himself. Now, for the second generation, there is already an organization of a certain size. In a start-up activity or a craft-shop of perhaps 20 employees, one can only gain experiences in small organizations. In a larger organization, one is promoted in various transfers from smaller departments to ever-larger organizational units. These transfers have the prime purpose of increasing the experience of the high-potential candidate. And one experience is very important: How to cope with the size of the organization. Before being appointed to the helm of a large company with, say, several hundred employees one should have gained experience in managing a unit of a hundred employees. In developmental theory this is called "vertical development," referring to a person's capacity to function at different levels of authority and deal with increasing levels of complexity and change. This has to be developed over time and through practical experience. It can be assumed that a considerable portion of "failed succession" cases can be traced back to the successor being literally overwhelmed by the size and complexity of the task and the organization. One cannot learn "size" by general intelligence or studying books, one needs to live "size." Therefore, it is very helpful to gain outside experience in large organizations.

7 Learning to Take Responsibility

Then. as the final step in the learning program of general executive work, comes the objective "carrying responsibility." In an external company, the potential candidate might not achieve the levels of higher responsibility early on. Therefore, this phase of the learning program will be relevant for the career in their own company. This is the critical relationship between parent and sibling: Being independent in the area of responsibility, knowing when to ask, learning when to stick to your own ideas, and when to follow the intentions of the boss. This difficulty exists in any succession—even in large industrial enterprises for predecessor and successor. Here, too, the rapid change of all previous practices and strategies is a sure road to conflict with the predecessor who is still in the hierarchy. Respecting the good practice in the succession among non-relatives in large organizations would be helpful for the succession process in family enterprises, too. Coaching for the successor as well

as for the predecessor is an instrument for smoothing this process in such organizations. It could be deployed in family businesses to the benefit of all concerned.

8 Learning "Foreign Countries"

Ideally, one of these learning phases is combined with learning the "strangeness of foreign countries." An executive who wants to develop the international activities of his or her company has to learn to cope with the discomfort of a completely foreign environment. The late Berthold Leibinger owner of TRUMPF machine tool company, said in an interview: Neither he nor the TRUMPF company would have become what they became without his first engagement in an American machine tool company. Staying abroad for an extended period is a rich source of new insights and an enormous challenge to develop adaptability. Studying abroad can also be a great place to start. The condition being, of course, that the individual makes full use of this time to integrate themselves into local life, to make friendships with locals, and gain an affinity to the other culture in general.

9 Learning the Trade

As for learning the know-how of the trade, the specifics are typically known. It has to be reiterated that the know-how of the technology is essential for any executive. Therefore, even studies and professional orientation in Business Administration need to be complemented by a thorough understanding of the technology of the respective industry. Some years of outside experience would theoretically be helpful in this learning program too. However, it is unlikely that another company in the industry would allow the heir of a potentially competing family business to deep dive into the technology of the said company. Therefore, this trade know-how is acquired at home.

10 Learning About the Style and the Stakeholders

Many family businesses are successful in part because of the efforts put into cultivating unique relationships—with their customers, with their employees as well as with other stakeholders. Reputation, trust, and a high reliability of consistent behavior is one advantage of family businesses. Just as if the firm had a "personality" of its own. This personality is based on consistent behavior over time and, of course, facilitated by the long-term tenure of the top executive, which is so typical for family businesses. The successor will need to be aware of and understand this style and long-term relationships. Not because the style cannot be adapted over time, but in order to help him to comprehend the impact which the company's reputation has on its success.

11 Not "Coming Home Too Early"

The previous sections outline how valuable the experience in a "foreign" organization is. As a matter of fact: Every single year is valuable. However, one has to admit that in most cases we know, the senior asks the family successor to come "home" too early. This is a selfish motivation. The senior is afraid that the junior is getting too independent while making a career in external companies. The senior thinks that as much time as possible is needed for the transfer of their know-how, which he or she considers unique, to the successor. Anyway, in most cases, the senior wants the potential successor under his or her roof early. Sometimes this is also a convenient solution for the successor. But even then, the roof should be the one of a separate building—subsidiary—as far away from the headquarters as possible. An activity in a foreign country is the preferred solution in many cases we know. This gives various advantages: Position with responsibility, familiarization with the trade know-how, experience of the strangeness of a foreign environment—balancing the closeness and the distance to the parents.

12 Personality

Ah, there is one more thing needed for confidently taking the helm of a company. In addition to being a good manager and an industry expert, one needs "personality." Being an interesting, perhaps even impressive person. Personality is shaped by growing in life experiences, by cultivating traits, by acquiring insights, by education, by knowing what one is capable of and where the limits are and much more. Again, the variety of challenges and experiences helps to develop the facets needed to become a multidimensional personality. Traveling abroad, visiting conferences, being engaged in service clubs, all these are training opportunities. For example, the chapter of NextGen in the Family Business Network provides a multitude of project and educational activities which help the siblings to gain multidimensional experiences.

13 A Mentor

Looking at interviews with owners reporting on a successful succession, we found two common experiences. First, it was the appointment of the successor to a foreign subsidiary of the family company. Second, not that obvious in the Curriculum Vitae, there was a mentor to the successor. The mentor was a superior inside the organization or a board member or a coach outside the organization. He or she was somehow "between" the parent as boss and the successor. He or she was closer to the age of the seniors than to the successor and he or she was accepted as a trusted person both by the senior and the juniors. This mentorship was, in most of the cases, not really planned; it emerged in the practice and the importance was valued in hindsight. In some cases, one could gain the impression that the senior engaged a person as board

member or as trusted person for the family, with the second thought: Here is a person which could be approached and deployed in difficult situations. And indeed, such a concept proved to be helpful again and again.

14 Conclusion: Clarity About Timing

In order to conclude: The aspects listed above are to be taken into account in planning any career to the executive level. In large groups, there are staff capacities and procedures to enable such a process. Some of the aspects were covered in the section on "Development of executives in family enterprises" (C 1.). Being able to handle these generic challenges of career development is mandatory—specifically for the most important person for the future development of the company: The potential successor. Then one has to cope with the paradoxical situation that on the one side siblings have to gain independence from their parents in order to become autonomous adults and parents themselves. This process is hindered by an ongoing reporting relationship as employee to the boss who is father or mother. This paradoxical situation is acceptable for a limited period only. Therefore, a fixed date has to be set for the final transition right at the beginning. And in the interim, a mentor seems to be very helpful.

The Challenges and Benefits of Non-family Management in Family Enterprises

Hermut Kormann and Birgit Suberg

1 The Relevance

In succession planning, the senior shareholders have, for various reasons, a clear preference for a qualified sibling or a team of siblings. If there is no successor in the family who seems to be qualified to manage the company, the senior will not choose him or her for two very good reasons. The overriding priority of the owner is first to safeguard the sustainability of his own life achievement, the company. If the person's own child does not seem to support this aim, he will—as a typical entrepreneur—look for an option that solves the problem. The second reason might be even more important. Managing a business is a responsibility with enormous stress potential which requires robust health and self-confidence based on competence. Being charged with such a responsibility without the necessary resources poses a risk to physical and mental well-being. Each father or mother will try to protect their offspring from such a risk.

Considering selling the family business for want of a family successor is most likely a fundamental economic and emotional mistake. No other investment in the financial markets gives the equivalent financial and emotional benefits as a normally successful family business of one's own. Therefore, it is not wise to make the continuation of this business dependent on the existence or willingness of a qualified family member to directly run the family business. By appointing a non-family executive, the family can continue the ownership and, indeed, the guidance of their own company. Most of the large and old family companies in Germany are managed by non-family executives under the governance committee formed by the owner's

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family. This can be a very successful route for safeguarding the sustainability of the family business. However, it needs careful planning and still requires certain qualifications on the side of the owners. These qualifications are different from those required for running of a company, but not less important.

2 The Prerequisites

Each and every succession is a very complex project. Obviously, it is not easy in a non-family company either. It is a challenging task to transfer the responsibilities to a child. But it requires even more planning to transfer the task to a professional executive because this project comprises an agglomeration of different change processes.

First, the transition from first to second generation marks the definite evolution from the lonely entrepreneur to an enterprise. The founder started the business, he grew up with the business, could decide anything on the spot. At the outset, this kind of decision-making was the only route to survival. The consequences of this approach are that the company does not work without the founder at the helm of the organization. In order to be sustainable, the business activities cannot be dependent on a sole individual—be it the founder, a descendant of the founder of a genius of a professional manager. An organization rather than an individual has to be the foundation of the business. An enterprise must be construed in such a way that the potential change in the management can be accomplished without major risk.

Second, the appointment of a professional manager necessitates a *professional selection process*—otherwise one would not select the candidate who fits the position best. Owner managers have a fatal tendency to do this task on their own and to select exactly the wrong person. Their business success leads them to the overconfidence to be qualified also in the task of selecting their successor despite not having the experience in such a task.

Third, for the selection and for the ongoing assessment, the respective criteria of *professionalism* are required.

Fourth, the appointment of a non-family executive works only within the framework of *a professional governance structure.* Mom and dad and some relatives meeting once a year for a shareholder assembly or two times a year for a kind of board meeting would not do the job. A professional manager is entitled to owners who are capable of and willing to provide clear guidance and monitor the progress in a professional manner.

Fifth, the non-family executive is a dependent employee. He or she deserves *fair treatment in all aspects of employment*. The commandment of fairness is specifically important should the employment be terminated.

3 Professionalism

Now, we often use the term “professionalism,” but what exactly do we mean? The basis of the term is the profession. Profession is a vocation that is accepted by society. The society connects certain obligations or at least expectations with the profession. The medical doctor has the obligation to avoid harm first and then the expectation to improve the health of the patient. The architect has the obligation to design buildings that are safe and durable and further he has to meet the expectation to design beautiful or impressive buildings. A legal advisor has the obligation to defend the interest of the client and he or she has to meet the obligation to have a thorough knowledge of the law. In the course of history, strict regulations have been imposed on the members of these professions by the government. The informal or formal regulations comprise a certain body of knowledge, a range of mandatory competencies, and—very important—a set of norms that are to be observed by the professionals. A training period, certain academic titles, or a minimum of practical experience are the proof of the competence. One of the general and overriding norms for a professional is the loyalty to the client who engages the professional. Another obvious norm is the principle of legality and morality. Quite often there are conditions set to become an “authorized” member of the profession. There might be a certain certification required by an independent authority confirming that the standards of the profession are met by the applicant. For us, the important aspect is that the professional does not have only to command a solid basis of knowledge and experience, but also has to comply with ethical standards of behavior and with standards of performance stipulating what has to be achieved by the professional work.

When it comes to managers, society has not yet come to a convincing consensus on what the standards of behavior should be. This is linked to two peculiar aspects of the managerial activities. On the one hand, the performance level is unlimited: the maximum of shareholder value is to be achieved—within the boundary of laws and moral standards. One the other hand, there are no norms stipulating how this performance can be implemented. There are no economic laws equivalent to the laws of natural sciences which describe a determined cause-and-effect relationship. Therefore, there is no guarantee that the targeted results can be achieved in reality. A little bit of art is still included in the profession of management. But, after almost 100 years of research and teaching of Business Administration, there is an impressive body of knowledge and a professional manager is expected to master a practice that is state-of-the-art.

Thus, the first commandment for professionalism is the mastering of the competencies required for the task of the respective manager. These competencies usually require a solid basis of functional expertise such as finance and controlling or manufacturing or marketing. This basis must be augmented by the leadership competence. Professional competence comprises an awareness of the limits of authority and the willingness to ask experts for support in issues outside the scope of their own competence. The awareness also covers the difference between knowledge of something and the mastering of a task. Mastery requires talent and devotion

plus repeated practice in any given undertaking. Further, maintaining professional competence requires a commitment to life-long learning in order to update the body of knowledge.

The second complex included in the construct of professionalism is the expectation that the professional has high personal standards of behavior. These standards can be labeled Values or Code of Conduct. Rakesh Khurana and Nitin Noria describe in a famous article "It's Time to Make Management a True Profession" in Harvard Business Review (October 2008) such basic standards. These stipulate—among others—the following obligations: The interests of various constituencies are to be balanced and reconciled, personal interests of the manager will never supersede the interests of the enterprise, the laws will be respected both in letter and in spirit, the performance of the enterprise will be communicated to the stakeholders accurately and transparently, personal orientations of the employees will be respected, diligence, mindfulness, and conscientiousness will govern the managerial judgment and activities. Other authors emphasize the ways and means of acting as a manager: Strict fulfillment of obligations, focus on facts, courage to stand for one's convictions, courage to take unpopular decisions.

These general commandments for the managerial profession are augmented by internal regulations, which can be labeled (J. Evetts) as "organizational professionalism." In the context of the business organization today, this comes under the umbrella of the *governance* of an organization.

A manager who meets all these obligations to develop and maintain his or her competencies has a certain self-esteem and expects that this expertise is respected by others. This is the first commandment for dealing with professional managers: The owner, the principal, has to respect the competencies of the professional. Based on these competencies, the manager is enabled and feels entitled to an autonomous judgment on issues at hand. The principal can argue and request that the owner's point of view is taken into account. The owner can support these arguments by highlighting the fact that the owner has to carry the consequences of a decision. But he cannot simply instruct the manager to do something because he or she owns the company. In the eyes of the professional, ownership entails wealth and responsibility, but not competence or wisdom. It would not be in the best interest of the owner either, to degrade the manager to the position of a clerk working to instructions given him. And no competent and proud manager would accept such a position. Exactly this is one of the important advantages of a governance system: To create a platform that facilitates and requires the exchange of arguments instead of giving instructions.

4 The Benefits of Governance for the Executive and the Owners

Let us first address the question of why a governance board is in the interest of the executive. The board has to explicitly formulate the interests of the owner, their overriding targets. In family companies, these targets are less about profit ratios, but more about excellence in the product performance or thriving innovation and growth

in order to safeguard the sustainability. The overall targets are typically not controversial. The concrete issues are more in the details and the ways and means of implementation. Can one cooperate with another company or does that endanger the independence of the family business? Can one accept an increase in the financial leverage in pursuing the growth target? Is the quest for profitability and the reduction in the staff, which is necessary, in harmony with the traditional culture of the family business? A board which meets its duty of specifying the targets for the management has to discuss these issues with the management and to formulate some kind of guidance. Such a process is based on a mutual exchange of arguments and it leads to a well-considered orientation which will be changed only when new insights emerge. Such a process might seem complicated for founder-owners who were able to change their plans without delay and could follow their gut feelings without further justification. Exactly this is the difference and the necessary development in the evolution from entrepreneurship to enterprise.

In strategic projects, the expertise of the board members can contribute know-how which cannot be provided by the founder and his/her family shareholders themselves as they have experience only in their own business or the relevant industry.

Governance is, of course, even more important for the principals to secure the alignment of the actions of the management with the interest of the owners. The governance practice offers a broad range of tools to this end: Analysis of the situation, defining issues for the agenda of the top management, specifying the limits of authority and corresponding approval rights of the board, evaluating the performance of the management, and designing a remuneration system which sets appropriate incentives are the essential activities of the board.

There are many aspects to a best practice of governance. But a family company should not start such an exercise with the usual quest for excellence. The important thing is to get started, but to get started—right at the beginning—with outside board members. It is essential to establish the practice that the family cooperates with non-family members in the board. This will lead to professional procedures. It has only advantages: Deploying the expertise of outsiders in strategic planning and developing professional procedures to provide guidance and to evaluate performance.

Professional Executive Search for Family Enterprises

Hermut Kormann and Birgit Suberg

A professional executive needs to be searched for. Regularly the senior entrepreneur is the one who has to plan and execute such a project. In doing so, this person has to solve two issues in which he or she does not have their own experience.

First, the entrepreneur has to visualize the step from a founder-managed business to an enterprise. The founder started the operation and took it from "Zero" to "One." He or she acquired the first customers and hired the first workers; designed each and every step of the developing company. Thus, he or she knew everything "from scratch" and was competent enough to take any arising decision. The founder-owner was kind of self-employed. This mental model of the first generation cannot be continued into the next generation. There cannot be a successor—from the own family or from outside—who has the same personal experience covering the whole historical development of the company. Second, the size of the operation has been enlarged significantly during the era of the founder. Managing the larger enterprise requires organizational capabilities and leadership techniques which the founder never needed. To summarize these aspects: The founder-owner has to find an executive for a task which they themselves are not familiar with: managing an enterprise instead of acting as an autonomous entrepreneur.

This new challenge has a collateral in the other challenge: The founder has to find a professional executive. This is a category of people that, most likely, has not yet been included in the top management team. In all likelihood, this team is formed by the crew of the early days in the start-up activity. Thus, we have a situation with two unknown tasks to solve. One has to find an unknown category of person for an unfamiliar kind of role in an enterprise.

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As our founder-owner in the assumed case has been very successful as an entrepreneur and has been used to deciding all upcoming issues himself he takes up this new task full of confidence. In this case, it could well be an “over-confidence.” There are some typical errors that founders make in searching for their successors. They meet an interesting young person, learn about their promising talents, admire their courage, and come to the conviction: This is the ideal candidate. This enthusiasm for the right person seems to make any comparison with less gifted candidates redundant. Another trap for the owner is being attracted by the wide area of responsibilities of managers in the higher echelons of large, global corporations. People who are responsible for billions of sales and thousands of employees seem to be the right candidates for fulfilling the growth aspirations of our founder.

Whenever a decision is based on too much enthusiasm the risk is high that the expectations are disappointed by a less glorious reality. A survey of the international executive search consultants, Egon Zehnder, came to the really frightening results: About half of the newly hired top managers leave or have to leave the company again within the first 2 years after the engagement.

As hiring the CEO of a company is one of the key success factors there is no room for a dilettantish approach or trial and error. The minimum the principal has to do is to allow for enough time to plan and execute the project. Further, he should draw on professional advice from experts who have proven experience in similar projects. To engage any qualified executive search firm would not yet be sufficient. The large search firms in Germany have partners specializing in the search for family-business executives. There are even smaller consultant practices that are focused exclusively on this service segment. This specialization is helpful in clarifying the requirements of the family shareholders and in identifying the potential candidates. It is not only necessary to find a professional executive but also one who has the mindset to adjust to the specific requirements of the family environment in the family business.

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The Trade-Offs of Incentive Programs in Family Enterprises

Hermut Kormann and Birgit Suberg

1 The Relevance

In all professional vocations, it is usual that more work generates a higher income. The medical doctor, the lawyer, the architect who works more will write more letters of liquidation. However, these invoices are not—at least in Europe—linked to the specific result of the professional involvement. This is not considered necessary as it is taken for granted that the professional will work to the best of his or her ability in the interest of the client.

In business, we used to have a similar tradition up until the 1970s. Already at that time, it was standard practice to award a bonus at year-end to the top executives. This was an arbitrary amount reflecting the quality of the business results as well as the personal efforts of an executive in a special project.

Then came two movements. First academic scholars detected—or some may say: invented—a structural conflict between shareholder (the principal) and executive (the agent). The reason for this conflict is differing interests. This is human and natural. The problem was that the scholars claimed that the agent is primarily or only interested in pursuing his or her selfish interests.

The second movement was that the scholars proposed that the interests of the principal-shareholders are focused only on increasing shareholder value. The shareholder value consists primarily of the increase in the share price and to a lesser extent in the profit payout. The problem with this concept lies in the fact that the share price reflects the expectations of the market investors of the future development of profits. This future however is not the long-term future but the next 1 or 2 years. And

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increasing these profits might require decisions that are negative for long-term development.

2 The Patterns of Incentive Schemes

In order to push shareholder value, the public companies introduced incentive schemes linked to shareholder value. Incentive scheme means that the payout can be calculated: The intent is to link a substantial financial benefit to a relevant performance indicator by applying a mathematical formula. For public companies, the share price (plus dividend) was this performance indicator. There is a wide variety of schemes with different elements of incentives. The first and basic incentive is the allocation of shares in kind or purchase options. This is intended to create an "ownership" relation between the agent and the company.

The second element is, of course, the potential increase in share prices and the gain from selling at that higher price. This is an incentive to elevate the profit expectation by the company's actions, results, and strategic announcements.

In this endeavor to provide incentives, the question arises of whether family companies should provide an equity participation to their top management or even to all employees. One should be careful because there are substantial differences to the situation at stock listed companies. A basic principle would obviously be that such a management-participation could not have more rights than the shares of the owning family. This leads to the following restrictions:

- Not the full profit per share can be distributed but only the rather moderate payout quota of 20% up to 35%.
  The payout amount is typically around 1% or a maximum of 2% of the value of the shares. Thus, in order to get a cash bonus via dividend of—say—200,000 USD, an underlying participation with a value of more than ten million. USD would be required.

A sober calculation of the implications will most likely lead to the conclusion that a decent cash bonus—partially linked to long-term growth performance—is an easily understandable and workable concept for non-listed family companies.

- The appreciation of the intrinsic value cannot be paid out to the manager when leaving the company. The family business would not survive if shareholders could easily exit the company and redeem the full value of their shares. Imagine that the above-mentioned share value doubled within 10 years: the increase in share value would be ten million USD which could be claimed at exit (on top of the pension benefits).

In start-up companies, the conclusion might be different. Here is the equity participation a well-established instrument in order to reduce the cash-payments for salaries. There is also an exit for the participation. The plan for the start-up is

generally to go public or to sell it to a larger (public) company. This has typically nothing to do with the dynastic intentions in family businesses.

3 The Trade-Offs

After two decades of ever higher, ever more complex incentive schemes, we are now seeing a phase of reassessment of the established schemes and experimentation with new patterns. This critical evaluation results from the following considerations:

1. You get what you incentivize! The majority of incentive schemes have a flat reference to profitability. Even long-term benefits are typically linked to long-term profitability. Such a focus neglects other even more important aspects such as customer satisfaction or growth.
2. In the cases where individual, non-financial targets are included, one needs to find a balance between incentivizing too many and too few targets. Too many items lead to a bureaucratic calculation of an average. Too few projects lead often to a disproportionate focus on extraordinary projects. The problem arises that the energy is concentrated on these projects to the disadvantage of the regular operation of the department.
3. There was a general tendency to grade inflation. A very natural tendency. Some companies tried to counteract this tendency by using the system of forced ranking. An example of this was General Electric's system of identifying a certain percentage of "low performers." This added to the bureaucracy while raising ethical questions.
4. Linking the incentives to the performance (profit) of sub-units strengthens the divisional egoism. This negatively affects the performance of the whole company.
5. There was a general complaint about the bureaucratic mechanics of handling the incentive system: Evaluating different criteria with points, meeting deadlines for the dialog with the employees, meeting deadlines for submitting the targets, meeting deadlines for the evaluations.

4 Some Maxims

Taking into account this critical evaluation we propose the following "reasonable" system of benefits:

1. Do not interpret incentivizing as a substitute for leading.
   Leadership is about giving orientation on what is expected from your employee and influencing and enabling the employee in order to meet the expectations. One cannot accept a substandard performance simply because it is penalized by negative marks in the incentive calculation. At best these marks might reinforce

the leadership intervention. However, with appropriate leadership communication, such reinforcement should not be necessary.

2. Do not interpret incentivizing as a substitute or essential element of recognition. Leadership implies recognition of the efforts and of the achievements as their result. The contributors deserve this expression of recognition.
3. Therefore, leadership should be practiced without the intermediary of detailed incentives.
4. The financial bonus is then just a form of participation in the overall performance of the whole company—not solely of a subdivision.

   Assessing the performance of subdivisions should be an element of the leadership process. Performance participation is related to the whole company in order to foster cooperation and solidarity. Even financial performance is not profitability alone but comprises growth as a vital element. For the family enterprise, sustainable growth is far more important than pushing the profitability ratio higher and higher. With respect to the economic cycles, the trend in the growth of the corporation is relevant. The trend can be measured relative to an industry average or—even better—as a trendline over time. Measuring the trendline over 5 years should balance out most of the short-term fluctuations.
5. The most important basis for sustainable development is the quality performance. Thus, a threshold benchmark for customer satisfaction or quality performance should be included in the performance measurement.

The Family Is the Destiny of the Enterprise

Hermut Kormann and Birgit Suberg

A family business is firstly a business which is secondly owned by a family. The destiny of the family and the destiny of the business are intertwined—for better or for worse. One has to accept the destiny, has to make the best out of it, but cannot change it by willpower. A businessman needs a lot of luck in his destiny.

A business needs a founder who finds the business opportunity and dares to invest money and time to start his or her own activity. Research analyses the history of the start-ups which today have proved to be successful businesses. There seem to be some common ingredients needed for starting a business. The first is the desire of the founder to be independent as a businessperson. He or she leaves an existing employment situation in order to do "their own thing." This is worthwhile to note. It is not first the unique idea of the compelling marketing concept which is at the beginning of an entrepreneurial career but the wish to stand on one's own two feet—economically. Second, the founder needs to find an opportunity. "Opportunity Recognition" is an emerging field of scientific inquiry. The opportunity has two roots: Firstly seeing that something is needed for which customers are willing to pay, and secondly being able to deploy one's own know-how to exploit this opportunity. In order to develop from this idea into an ongoing business activity, two further components are needed. There are people who help to raise the financing required for the start-up, and then there is (in many stories) a valuable person giving advice, establishing fruitful contacts, giving an important order. And then, not at the very beginning but a little further into the march, within the first miles of business development, the founder needs to find a specific product or customer or way of doing business. This innovation gives him or her tailwind for a successful period of

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growth and profitability. As the company expands, this wave of initial success might level off to a normal, but more steady, the evolution of the activities. Thus, in hindsight, starting a business is—in most cases—not the result of a magic moment of enlightenment but a sequence of courageous, industrious, and lucky steps.

Thus, we can summarize: It is, of course, hard work but also good luck which leads to the establishment of a family business. Around the same time when the business is founded, is often when a family is founded too. Otherwise, there is no family business with succession. This project might be based on the same mood of optimism which nourishes the business idea. This needs a whole string of lucky events: Finding a partner, falling in love, receiving the gift of offspring. And then, eventually, the child should develop sympathy for the family business. He or she must consider the business as a vital element of the family. To this end, the education should include an awareness of the value of capital and investment of capital. A psychological experiment which has become famous is the marshmallow test. It demonstrates the value of delayed gratification which stands for the benefits of investment. Those children are better equipped for future adult life who can wait some time in order to get—as promised to the waiting group—two marshmallows, instead of asking soon for the one single marshmallow available immediately. In one interview, we asked the shareholder of a very old private bank what he and his wife do in order to educate their children to get used to the wealth of the family. The answer focused on the various ways of learning to save and to delay expenditures. This includes learning to economize with the pocket money early on. At the age of 16, the child should get his or her own small investment account to see how the value of the accounts accumulates over time. Thus, the father could summarize: Yes, my children know that they will be considered wealthy, but they are thrifty. Specifically, in the German society of family owners, it would be considered inappropriate to indulge oneself in excessive or even demonstrative consumption. An entrepreneur has always to economize because he is always keen to look for opportunities for investment. There is however one exemption even in the thriftiest entrepreneurial families: Purchasing a premium car is not luxury but apparently some kind of investment (but only German premium cars are counted as such, Italian cars are pure luxury).

Today, parents know that they cannot instruct their children which profession to choose. The child will and should elect the professional education they are interested in. Here, in Germany, we no longer consider a succession in the management role as vital for the continuation of a family business. The offspring could also assume a role in the governance of the company and engage professional managers to run the business. Owners can sufficiently influence the development of the company and contribute to shaping the character of the business as a family business. A prerequisite for this role of a professional owner is that the shareholder has a profession and has enough understanding for business in general.

Whereas the founder had to have the luck to start his business, the next generation has the benefit of inheriting a going concern. Nevertheless, the second generation also has its challenges. They too, need good luck to cope with them. There is the need to muddle its way through a major recession. History tells us that in each and

every half-century, the world experiences a severe crisis. Fifty years represents one and a half generations. One needs perseverance and good luck to bridge this downswing. Research demonstrates that family business owners demonstrate resilience in difficult times. Family capital is "patient" capital.

Thus, with a sustainable business model and patient capital, a family and its business could live happily ever after.

However, there is the downside, too, of the close connection between the owner family and their business. If the family falls apart through conflicts, the business might also fall apart. We think the likelihood and the severity of conflicts might be overrated in the literature on family business. There are by far more families cooperating harmoniously than conflict-laden ones. Further, the statement made by Mr. Zinkann from Miele is certainly true: "Success of the business is a good glue for a family." A good business strategy is conducive to harmony. However, if there is no glue left, if disputes escalate to conflicts or even wars, then the family will become a destiny to the business for the worse. If a family is not willing or able to develop the business themselves, they might rather be inclined to make really big money by selling the business to the financial markets or an investor. This means the end at least for the family character of the business. In such a case even a lucky deal might be bad luck. Because being rich is not enough for happiness. Serving a meaningful purpose, seeing the sense of what one is doing, these are the ingredients for happiness. Owning a family business involves a lot of "sensemaking." Research has coined the term "socioemotional wealth" for this enrichment through engagement for a meaningful purpose. Each owner can consider himself or herself lucky for participating in this wealth.