

# **Chapter 2**

## **Small and Medium-Sized Enterprises**

### **2.1 Preface**

This chapter outlines the role of small and medium-sized enterprises (SMEs). The first focus is on the nature and importance of SMEs in Europe. The categorization of SMEs in the 1990s as well as today's classification will be explained. This is followed by a detailed table of the new thresholds determined for SMEs within the European Union (EU). After that, both the necessity and the benefit of the new definition of SMEs will be pointed out. With reference to their pivotal role, some hard facts concerning SMEs and their aims will be revealed. Definitions of SMEs in Germany have been provided by the Institut fuer Mittelstandsforschung Bonn (IfM Bonn) and by the Kreditanstalt fuer Wiederaufbau (KfW). After introducing NEWCO International GmbH, the case study of this survey, it will be shown how it links to the definition of SMEs in Germany. At last, the difficulties faced by SMEs as well as the advantages of SMEs will be explained before a final summary is given.

### **2.2 Nature and Importance of SMEs in Europe**

To begin with, it needs to be stated that there is no formal definition of SMEs. At the beginning of the 1990s, the European Observatory for SMEs defined them as enterprises employing less

than 500 employees.<sup>1</sup> At that time, enterprises which employed more than 500 employees were regarded as large sized enterprises.<sup>2</sup> Nowadays, SMEs are defined as enterprises with less than 250 persons employed. In addition to the staff headcount, new thresholds such as the annual turnover and the annual balance sheet, are further criteria.<sup>3</sup> Table 2.1 shows the categorization of all thresholds.

**Table 2.1** The new thresholds for SMEs in the European Union<sup>4</sup>

Enterprise category	Headcount: annual work unit	Annual turnover	Annual balance sheet total
Medium	<250	≤ € 50 million (in 1996 € 40 million)	≤ € 43 million (in 1996 € 27 million)
Small	<50	≤ € 10 million (in 1996 € 7 million)	≤ € 10 million (in 1996 € 5 million)
Micro	<10	≤ € 2 million (previously not defined)	≤ € 2 million (previously not defined)

The *headcount* determines in which category an SME falls. The *annual turnover* is based on the earnings realized over a year, after deduction of rebates and excluding value added tax and other indirect taxes. The *annual balance sheet total* refers to the value of a company's main assets. When trying to classify a company, the *headcount* AND the *annual turnover/annual balance sheet total* have to be chosen. The headcount can be easily determined. In a second step, the *annual turnover* OR the *annual balance sheet total* need to be calculated.<sup>5</sup>

<sup>1</sup>Cf. 'The European Observatory for SMEs' (1994), p. 1.

<sup>2</sup>Cf. Bates, P. J., Furminger, M., Haldane, A. (1995), p. 3.

<sup>3</sup>Cf. 'Observatory of European SMEs' (2003b), p. 4.

<sup>4</sup>Cf. [http://ec.europa.eu/enterprise/enterprise\\_policy/sme\\_definition/index\\_en.htm](http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/index_en.htm); 'The new SME definition' (2005), p. 14.

<sup>5</sup>Cf. 'The new SME definition' (2005), p. 15.

It is necessary to distinguish between these categories to get a clear picture of a company's economic situation. Based on this common definition of SMEs within the EU, comparisons of national and international companies can be consistent and effective.<sup>6</sup>

In 2005, there were approx. 23 million SMEs in the European Union which at that time consisted of 25 member states. Providing around 75 million jobs and representing 99% of all companies within the EU, these enterprises are important contributors to growth, competition and productivity.<sup>7</sup> It can therefore be stated that 'Micro, small and medium-sized enterprises are the engine of the European economy. They are an essential source of jobs, entrepreneurial spirit [. . .] and are thus crucial for fostering competitiveness and employment.'<sup>8</sup> Their competitiveness is improved through good management of the relationship with their distribution networks.<sup>9</sup> For the reasons above, SMEs in Europe are also called the real 'giants' of the European economy.<sup>10</sup>

## 2.3 SMEs in Germany

The previous section was necessary as there is no uniform definition of small and medium-sized enterprises. Depending on the purpose, several characteristics for the differentiation of SMEs are conceivable.<sup>11</sup> Contrary to the thresholds laid down by the EU, the Institut fuer Mittelstandsforschung Bonn (IfM Bonn) defines SMEs as follows (Table 2.2):

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<sup>6</sup>Cf. 'Commission recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises' (2003a), p. 36.

<sup>7</sup>Cf. 'SME consultation 2007/2008' (2008), p. 1; 'The new SME definition,' op cit., p. 5.

<sup>8</sup>Verheugen, G. (2005), p. 3.

<sup>9</sup>Cf. Alzaga Etxeita, A., Goyarrola Ugaalde, J. (2003), p. 2.

<sup>10</sup>Cf. 'Mittelstand: Leistung durch Vielfalt' (2009), p. 3; 'SMEs in focus' (2002), p. 4.

<sup>11</sup>Cf. 'Der Mittelstand in der Bundesrepublik Deutschland: Eine volkswirtschaftliche Bestandsaufnahme – Dokumentation Nr. 561' (2007), p. 9; 'Die volkswirtschaftliche Bedeutung der Familienunternehmen' (2007), p. 3.

**Table 2.2** Thresholds of SMEs in Germany by the IfM Bonn<sup>12</sup>

Size of enterprise	Headcount		Annual turnover
Small	<10	AND/OR	< € 1 million
Medium	10–500		€ 1–50 million

Companies with more than 500 employees and more than 50 million Euros turnover are large enterprises.<sup>13</sup> In 2007, a total of 3.63 million companies<sup>14</sup> existed in Germany. 99.7% of these companies were small and medium-sized enterprises, accounting for 38.3% of all turnovers and 70.6% of all employees in employment.<sup>15</sup>

Unlike the EU definition, there is not only an AND-connectivity between headcount and annual turnover in Germany. The evaluator can decide on his own whether the headcount AND/OR the turnover is used as a criterion resp. criteria.<sup>16</sup> The decision on a criterion often depends on the availability of the relevant data. If, however, a company is defined as an SME in a statistic, it is necessary to indicate the criterion.

The Kreditanstalt fuer Wiederaufbau (KfW) defines companies with a maximum turnover of 500 million Euros as SMEs.<sup>17</sup>

## 2.4 NEWCO International GmbH

The results of this book are based on an investigation carried out for a really existing company. For reasons of confidentiality, however, the company name was anonymized.

<sup>12</sup>Cf. <http://www.ifm-bonn.org/index.php?id=89>.

<sup>13</sup>Cf. 'Der Mittelstand in der Bundesrepublik Deutschland: Eine volkswirtschaftliche Bestandsaufnahme – Dokumentation Nr. 561,' op cit., p. 9.

<sup>14</sup>Cf. 'Arbeitsbericht 2008' (2009), p. 11; All companies with more than 17.500 Euros taxable annual turnover resp. companies with minimum one employee subject to social insurance contribution are considered.

<sup>15</sup>Cf. 'Mittelstand: Leistung durch Vielfalt,' op cit., p. 7.

<sup>16</sup>Cf. 'Der Mittelstand in der Bundesrepublik Deutschland: Eine volkswirtschaftliche Bestandsaufnahme – Dokumentation Nr. 561,' op cit., p. 9.

<sup>17</sup><http://www.bwmd.de/Mittelstand/Definition/>.

NEWCO International GmbH (hereinafter called NEWCO) is a fictitious sales and trading company for specialty chemicals. NEWCO is located in Cologne/Germany and employs approx. 50 persons. Its turnover in 2008 was approx. 73 million Euros. Its portfolio comprises some 350 products which are delivered to 1500 customers in 80 countries.<sup>18</sup>

NEWCO serves customers worldwide who have come to appreciate the company's comprehensive and uncomplicated service offered by its sales representatives and technical marketing. NEWCO is a reliable and competent partner with a profound know-how, based on decades of experience as a chemical distributor. The company's aim is to develop tailor-made solutions for customers.<sup>19</sup> Thanks to its good distribution network, it has direct access to content that supports the daily business, thus making the business more efficient and reducing the search time.<sup>20</sup>

Based on the definition of SMEs in Germany and when applying the OR-connectivity, NEWCO International GmbH falls in the category of medium-sized enterprises. Its headcount of just under 50 is lower than the 500 employee threshold.<sup>21</sup> However, when applying the definition of the KfW, NEWCO can also be seen as an SME. Its turnover of approx. 73 million Euros is lower than the limit of 500 million Euros.<sup>22</sup>

## 2.5 Difficulties and Competition Factors of SMEs

Despite their high importance in Europe, SMEs are confronted with a lot of obstacles. One of them is to obtain capital or credit, especially in the start-up phase. This is a constant problem that

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<sup>18</sup>Data taken from internal company profile: 'Firmenpräsentation 20090525.pdf' (2009), p. 2.

<sup>19</sup>Data taken from internal company profile: 'Firmenpräsentation 20090525.pdf,' op cit., p. 4.

<sup>20</sup>Cf. Alzaga Etxeita, A., Goyarrola Ugaalde, J., op cit., p. 3.

<sup>21</sup>Cf. 'Firmenpräsentation 20090525.pdf', op cit., p. 2; <http://www.ifm-bonn.org/index.php?id=89>.

<sup>22</sup>Cf. 'Firmenpräsentation 20090525.pdf', op cit.; <http://www.bwmd.de/Mittelstand/Definition/>.

SMEs encounter, because they are often unable to offer securities to money lenders and investors. The current financial crisis reinforces this problem.<sup>23</sup>

Another factor is that, due to restricted resources, they have reduced access to new technologies and innovation.<sup>24</sup> Compared to bigger companies, they have a lower capacity for modifying their external environment. Therefore SMEs need to focus on areas that represent real chances of business improvement instead of wasting too much capacity on any opportunity for improvement that may come up.

The fluctuation of employees and their intellectual capital is a further problem that companies are faced with. Especially in SMEs, the loss of employees threatens the availability of intellectual capital.<sup>25</sup> In the last years, the lack of skilled labor has been considered to be the main obstacle for SMEs in Europe, and hence also Germany. In addition, it is difficult for SMEs to find the right balance between confidentiality (hiding information) and sharing knowledge. But this is essential for successful networking.<sup>26</sup> In brief: SMEs have problems caused by the fluctuation of employees – in other words: loss of knowledge. On the other hand, they have difficulties in handling the knowledge. This is confirmed by a survey – carried out by Beijerse in 2000 – on KM practiced in SMEs. He found out that there is a clear lack of systematic knowledge management policies.<sup>27</sup>

The majority of SMEs compete on the service that they provide to the customer and on the quality of their products and services. Therefore, (i) customer service and (ii) quality are the major competitive factors for SMEs (see Fig. 2.1).<sup>28</sup> This can give them considerable competitive edge over big companies. The

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<sup>23</sup>Cf. <http://www.manager-magazin.de/unternehmen/flexindex/0,2828,650275,00.html>; 'The new SME definition' (2005), p. 5.

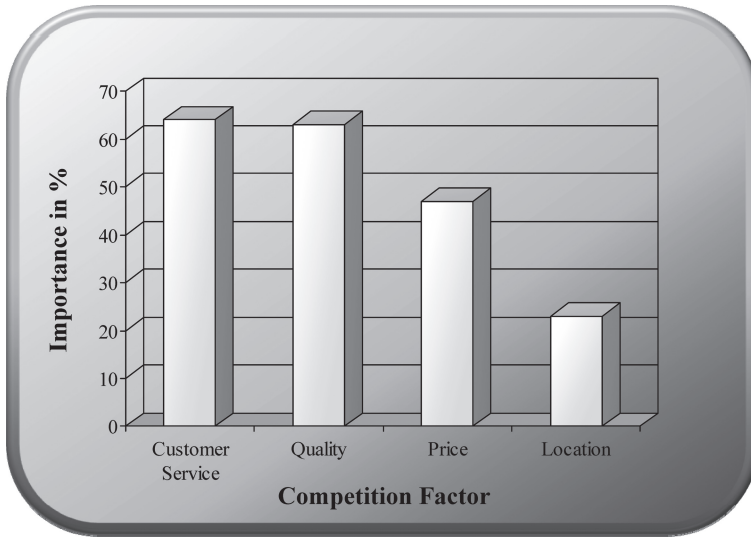
<sup>24</sup>Cf. 'The new SME definition' (2005), p. 5.

<sup>25</sup>Cf. Coviello, A. et al. (2002), p. 14.

<sup>26</sup>Cf. 'SME and Entrepreneurship Outlook' (2005), p. 124; 'SMEs in focus' (2002), p. 9.

<sup>27</sup>Cf. Beijerse, R. (2000), p. 162.

<sup>28</sup>Cf. 'SMEs in focus' (2002), p. 8; 'Working to Ensure Benefits from the GATS for Members' Small and Medium Sized Enterprises (SMEs)' (2005), p. 1.



**Fig. 2.1** Factors on Which SMEs Consider Themselves Competitive<sup>29</sup>

following diagram shows the priority of competition factors for SMEs.

The graph shows that the factor price figures only in third position while location ranks only in position four. This clearly shows that customer orientation is the most important competition factor for SMEs. Good relationships build trust which is needed for future business. It is obvious that quality is also important for gaining a competitive edge. These two factors are the ‘ace in the sleeve of the SME’ for gaining competitiveness.<sup>30</sup> Chapter 5 will deal in particular with the aspect of customer relationship.

Another factor that makes SMEs competitive is their flexibility to react to change. Thanks to their small dimensions, SMEs can act and change faster than larger companies. Change means the ability to adapt management tools and strategies to newly arising market demands.<sup>31</sup>

<sup>29</sup>Cf. ‘SMEs in focus’ (2002), p. 8.

<sup>30</sup>Cf. Bryson, J. R., Daniels, P. W. (2007), p. 302; Hmelnitchi, C., Neamtu, I. (2009), p. 3.

<sup>31</sup>Cf. Coviello, A. et al. (2002), p. 14.

## 2.6 Summary

In this chapter, the pivotal role of SMEs in the EU was pointed out.<sup>32</sup> It can be stated that SMEs are more and more seen as important drivers for increasing the economy's competitiveness in the global market and essential for sustained, long-term economic stability.<sup>33</sup> They are the driving force in our economy.

In every business, independent of the sector, the size of a company or the kind of activity, it is obvious that the real company value is different from its book value. The difference, known as intellectual capital, is growing continuously, and this is an opportunity for SMEs to improve. Intellectual capital is an important success factor for these companies. The fact that they have to deal with employee fluctuation and therefore loss of knowledge, and the fact that they have difficulties in handling knowledge clearly shows that a knowledge management system is needed.<sup>34</sup>

To sum up, SMEs have some advantages but also need to tackle some crucial issues. To survive in our today's business environment, it is fundamental to minimize resp. eliminate these drawbacks. Knowledge Management supports an SME by making relevant data available at the right time and in the right place. The next chapter will therefore focus on the various facets of Knowledge Management.

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<sup>32</sup>Cf. Verheugen, G., op cit., p. 3.

<sup>33</sup>Cf. Menkhoff, T., Wah, C. Y., Loh, B. (2004), p. 6.

<sup>34</sup>Cf. Coviello, A. et al., op cit., p. 14.



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