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Legal entity simplification
Quantifying potential cost savings

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One negative side effect of Merger & Acquisition (M&A) activity in recent years is unwieldy legal entity structures. These complex structures tend to drive up costs across the enterprise, so it's little wonder that cost reduction is perhaps the most common driver of legal entity simplification efforts. But to achieve these cost savings, the enterprise must embark upon an entity simplification project, and these projects cost time and money. Company leadership will often demand an estimate of the potential cost savings before authorizing such a large effort. In the past, many companies have relied on "rules of thumb" regarding the cost savings (such as each entity eliminated provides $20,000 of cost savings). As discussed below, such high-level estimates are often poor predictors of actual results. This article provides a more rigorous method for estimating the cost savings that are possible with entity reduction efforts.

Categories of benefits

Pre-tax cost savings are not the only possible benefit from entity simplification projects. Other benefits that enterprises can derive include:

- Risk reduction — aligning the legal entities with the company's business model can increase the likelihood of using the correct legal entity for contracting, employment, etc. Having fewer entities can also make it easier to generate accurate separate-company legal entity financial statements, which are necessary to produce correct tax provision amounts.
- Ease of doing business — having fewer legal entities can make it easier for both customers and vendors to do business with the enterprise, especially if any particular customer or vendor must routinely transact with multiple entities within the group.
- Tax reduction — additional legal entities can trap tax losses and other attributes, causing the overall group to have a higher than expected tax rate. For example, if the group's third-party debt is at the parent company and the profitable operations are at the subsidiary level, many states will not allow the parent's interest expense to offset the subsidiary's profits, resulting in loss carryforwards at the parent level and full taxation at the subsidiary level.

Dimensions of cost savings

One danger to estimating cost savings on a per-entity basis is that the amounts can vary so widely as to be meaningless. For example, the annual cost to maintain a dormant U.S.-based entity might be only a few hundred dollars a year. On the other hand, the cost to maintain a duplicative operating entity that does business in a European country might be more than several hundred thousand dollars per year. So, attempts to estimate cost savings based solely on the number of legal entities eliminated usually end in frustration.

The critical dimensions of cost savings are:

- Location of the entity — U.S.-based entities tend to have lower costs to maintain compared to many other jurisdictions, which may have statutory audit and other entity-based requirements.

- Activity of the entity — dormant entities can be easier to eliminate than operating entities, but dormant entities typically have a trivial cost to maintain compared to operating entities.
- Level of simplification — larger cost savings are possible when an eliminated entity's activities are completely absorbed in another entity's routine activities, rather than continuing to exist separately in the surviving entity. For example, larger cost savings are possible when eliminated entity's bank accounts are closed, rather than simply being renamed with the surviving entity's name.
- Level of prior integration/restructurings — many complex legal entity charts are the result of prior M&A transactions. To the extent that the prior integration work was successful at achieving synergies (for example, the enterprise previously moved to a single ERP platform), there generally will be less cost saving available.

With respect to pre-tax cost savings, most companies will find benefit in some or all of these areas:

Function	Sample savings
Legal and regulatory	Reducing fees and costs relating to redundant minimum taxes, licensing, permitting, registration, registered agent, public notices filing, record maintenance, state legal, tax compliance, and other filing.
Finance and treasury	Reduction in bank account service fees, transaction charges, capital costs associated with minimum deposit requirements, debt covenant compliance, and cash forecasting.
Accounting	Reduction in fees and costs relating to statutory audit, redundant and inefficient shared services resources, monthly/quarterly/annual reporting, intercompany accounting (e.g., streamlining voluminous intercompany journal entries and reconciliations), and IFRS implementation.
Operations	Reduction in costs that resulted from duplicative administrative/shared services, misaligned operating model, duplicative insurance policies/premiums, and intercompany accounting. Reduction in lost sales/revenue resulting from artificial barriers to doing business.
Information technology	Reduction in costs relating to general ledger input/coding, system configuration, and incremental system capacity.
Human resources	Reduction in costs relating to administrative and shared services, insurance/premium, vendor rationalization, and redundant compensation and benefits programs. Managing loss of employee mobility.

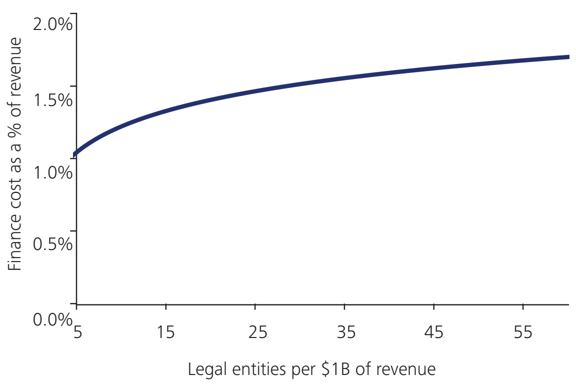
Quantification of cost savings

We have not been able to find a comprehensive database that shows, for enterprises that have implemented large-scale entity simplification efforts, the before and after-cost levels. In fact, many companies fail to carefully track the savings they are realizing, which we believe is a mistake. However, there is other data available that shows the magnitude of savings that may be available.

The Deloitte Consulting Benchmarking Center recently conducted a study of 400 enterprises, each with sales of more than $5 billion, in a variety of industries. The goal of the study was to determine whether there was a correlation between general and administrative (G&A) costs and legal entity efficiency. G&A costs were measured as a percentage of revenue, and legal entity efficiency was expressed as the number of legal entities required to produce a billion dollars of revenue. The study showed that companies that had higher levels of legal entity efficiency had lower levels of costs in both the finance and human resource administration areas.

As a caveat, keep in mind that this data was not drawn from individual companies, showing a cost for each company both before and after legal entity simplification. Instead, it shows, at a moment in time, the costs of hundreds of companies that had varying levels of legal entity structures. As you might expect, companies that had fewer legal entities per billion dollars of revenue had lower G&A costs as a percentage of total revenue. The inference is that excess legal entities drive up G&A costs and that reducing the number of legal entities would result in reduced costs.

Impact of number of legal entities on finance cost as a percent of revenue



Source: Deloitte Consulting Benchmark Center study

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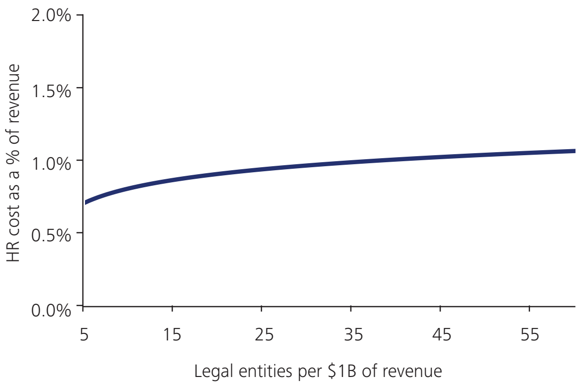
Impact of number of legal entities on HR cost as a percent of revenue



Source: Deloitte Consulting Benchmark Center study

The data would suggest that companies that had five legal entities per billion dollars of revenue have about $1.9 million lower finance costs per billion of revenue than similar companies that have 10 legal entities per billion of revenue. This would imply that a hypothetical company with $10 billion in sales and 100 legal entities could save as much as $19 million a year in finance costs if it eliminated 50 of its legal entities (about $376,000 per entity eliminated). This $376,000 in cost could be further broken as follows (in thousands):

Performance management	80
Transaction processing	79
General accounting	64
Tax and treasury	47
Controls and risk management	30
Other	76
Total	**376**

Source: Deloitte Consulting Benchmark Center study

The other G&A cost area that seems to be favorably influenced by entity simplification is human resources administration. For the same hypothetical $10 billion company that reduces its legal entities from 100 to 50, the potential human resources administration savings would be $11 million per year, or about $222,000 per entity eliminated. This $222,000 of cost savings could be further broken out as follows (in thousands):

Talent management	100
Transaction processing	29
Strategy and program design	24
Reward administration	20
Other	49
Total	**222**

Source: Deloitte Consulting Benchmark Center study

Limits to the benchmark data

As mentioned above, these levels of savings were not derived by studying before and after cost structures of enterprises that had simplified their legal entity structures. Instead, these amounts were derived by comparing G&A cost levels (as a percentage of revenue) with legal entity efficiency measurements. Thus, even if these companies were exactly like your company, the results could vary. In addition, it is likely that some amount of the excess cost noted above is merely correlated with legal entity complexity, and not caused by it. So, for example, enterprises that have widely varying business units will likely have higher G&A costs per billion of revenue, and they also would be likely to have more legal entities per billion of revenue. In those cases, reducing the number of legal entities without otherwise changing the business would likely result in some savings, but less than indicated above. For this reason, it is likely better to view these amounts as "best case" results, rather than average results.

Companies that are attempting to determine the cost/benefit ratio of their own proposed entity simplification project should keep the following in mind:

1. Determine where the enterprise is with respect to overall legal entity complexity — i.e., where the company would be placed on the public company legal entity continuum graph shown in Deloitte's piece "Legal Entity simplification — A Better Approach." Companies that are already in the most efficient half of the legal entity efficiency graph will have less upside than companies in the less efficient half of the data. Companies in the top 25% of the legal entity efficiency graph will find it much harder to identify substantial savings.
2. Consider the G&A cost benchmark amounts above, adjusted for your company revenue size (the amounts above were based on either a $1 billion or $10 billion revenue company).

3. Conduct the initial phase of a Straw Man approach, sketching out the future state as described. One of the advantages of the Straw Man approach is that it is relatively inexpensive to conduct, which is an important consideration if funding for a more substantial entity simplification effort has not yet been set.
4. Based on the Straw Man structure, ask function heads to estimate cost savings based on the difference between the current structure and the Straw Man structure. In the early stages of the project, it may be possible to justify further entity simplification effort simply by identifying the more visible savings. So, for example, the costs of statutory audits are relatively easy to capture, as is the number of hours spent reconciling intercompany accounts. Consider leaving the more difficult to measure savings areas for later states, or if it is unclear that the project is cost justified.
5. As the entity simplification progress moves forward, consider setting up a rigorous tracking process to identify and capture savings identified. It is possible to reduce the number of entities without much cost savings, if enterprises aren't careful. Remember the goal is not the reduction of entities per se, but the elimination of excess cost associated with those entities eliminated.

Conclusion

Entity simplification projects can yield substantial benefits, but they also can involve substantial costs. Before embarking on such a project, it is prudent to estimate not only the cost, but also the potential benefit to increase the likelihood of financial success. The data, tools, and processes listed above can support enterprises as they attempt to quantify potential savings from entity simplification projects.