This paper summarizes the themes and discussion points arising from EY’s third Why LEM Matters Webcast on 18 November 2014. The session was attended by participants from major corporates across a broad range of sectors.

1. Introduction

The Webcast covered the key topic of building a business case for a legal entity management (LEM) project or program. While in some instances there will be a self-evident case for a LEM project, in most circumstances, the ability to identify and articulate the expected costs and benefits will be essential to secure buy-in from senior management.

To set the scene, we asked participants what drives their efforts to manage their legal entity structures (see Fig 1).

Fig 1: Webcast 3, 18 November 2014: for which of the following reasons does your organization actively manage and review the legal entity* structure?

- Eliminating surplus entities: 31%
- Statutory compliance and reporting: 23%
- Tax effectiveness: 22%
- Operational efficiency and alignment: 24%
- None of the above: 0%

The lead finding, eliminating surplus entities, confirms EY’s view that many businesses are seeking to eliminate surplus entities in order both to reduce costs and as a preliminary step to driving further rationalization.

*Legal entity includes a company, partnership, limited liability corporation, trust or branch

Source: Webcast polling question data
Why build a business case?

There are a number of reasons for developing an LEM business case. These include securing engagement and buy-in from key senior stakeholders, a clear idea of costs and benefits and the relevant payback period, as well as serving as a tool to justify the likely costs of both internal resources and external professional advisors.

These benefits will fall into two broad categories – the quantifiable savings and the less easily quantified, but potentially more valuable, “softer” benefits. Within these two categories are opportunities arising from tax, IT and operations, legal considerations, and accounting and finance dimensions. In this paper, we’ll examine some of the approaches that a business can take to understand and capture the “hard” and “soft” benefits in each of the relevant areas.

A further key point to note is that LEM or rationalization does not take place in isolation from the rest of the business. It’s essential, therefore, that any proposed project takes account of broader strategic drivers and future strategic plans. A review of other projects taking place may reveal synergies, or could impair the progress of intended entity-related project. For example, one EY client was part way through a large ERP implementation that would have conflicted in terms of resource, with a proposed rationalization. Another had 26 other change programs under way that would have benefited from LEM, if only the rationalization had been integrated and planned into the wider change programs at the start.

Is a business case required?

When approaching an LEM project, the first question should be: is a business case required? In some cases, a project’s merits will be largely self-evident and its implementation likely to be straightforward.

For many cases, however, a business case will be required to secure buy-in from senior stakeholders, provide a credible account of the likely costs and benefits, and an indication of the time line for realizing those benefits. Determination of whether a project is aiming to achieve entity reduction (i.e., elimination of surplus, often inactive, entities) or structural rationalization (i.e., strategic redesign of the group) is also key.

Fig 2: Webcast 3, 18 November 2014: what does your organization perceive to be the biggest obstacle in building an LEM business case?

The majority of respondents cited the challenge they experience in identifying the soft cost savings, confirming that businesses are seeking to take a broader view of the benefits that LEM projects can achieve. The second most-cited challenge, accessing information, stresses the importance of engaging with the relevant stakeholders in the business.

Source: Webcast polling question data

4. Degrees of analysis: from light to heavy

There are three distinct levels of analysis – light, medium and heavy – that we typically see as being required, depending on the complexity of the proposed project.

The first level requires simple benchmarking from externally available data for the sector. This looks at average costs, and should take no more than two to three weeks to complete.

The next level requires greater analysis of internal company data. This will typically be focused on achieving a higher level of cost savings and will require a more detailed account of the projected benefits. It will need to take into account the likely costs of both internal and external resources, and should consider some of the softer benefits – for example the opportunity cost saved of management time spent on oversight of compliance matters – which may not be quantifiable, but should nonetheless be included in order to increase the chances of securing buy-in for an LEM project from senior management. We would expect a project like this, depending on its scope, to take between four to five weeks to complete.
As the business environment becomes more complex, legal entity rationalization has a key role to play in improving corporate governance. LEM can be an effective tool with which to align operational and legal organizations and structures. This is increasingly important; for example, in cases where group functions are operationally centralized, but are legally decentralized among local entities. That disconnect can cause problems with authorization of transactions, complexity of IT systems, billing, transfer pricing and other organizational issues. A project to bring legal and operational structures together can create greater transparency that will drive the clearer accountability that is essential for more effective management and greater control of the overall business.

In much the same way, improved governance leads to better risk management, with the ability to identify and ring-fence high-risk operations and limit exposure to particularly risky jurisdictions. A LEM project can also identify intergroup liabilities and eliminate those that are not necessary or required. That process also extends to directors’ personal liabilities, which are increasing in many jurisdictions. LEM can play an important role in limiting directors’ personal liabilities, and enable them to focus their time and energies on running the business.

These benefits are hard to quantify with precise monetary values. However, they are unquestionably important steps to achieving a solid and stable corporate structure that is a prerequisite for sustainable growth. They should therefore be reflected in a business case to support an LEM project.

5. Identifying benefits: hard and soft

Legal

There are some clear gains to be made from effective corporate “housekeeping,” for example, by liquidating or merging redundant or duplicative legal entities. Cleaning up the organization into a more rational structure will deliver a more streamlined and stable business.

While a relatively high proportion of respondents cite per-entity carrying costs of over £90,000, the majority fall into the £10,000–£60,000 (£12,600–€38,000) range, which is consistent with EY’s experience from most projects.

Finally, the most detailed analysis will be required for a significant redesign of trading entities. This transformational approach will necessitate extensive data and modeling for each entity in scope, and include determination of a wide range of benefits and costs, including an analysis of measures such as Net Present Value (NPV), and Internal Rate of Return (IRR). Instances where this highly detailed approach might be justified include a financial services business seeking to improve its capital efficiency or meet regulatory capital benefits. It’s likely to require between 10 and 12 weeks to complete.

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IT and operations

While IT and operational considerations are often viewed as stumbling blocks to LEM projects, EY’s experience suggests that taking a more holistic approach can, in fact, strengthen a business case.
Understanding the relative complexity of a proposed LEM project can help determine the likely scope and extent of the IT change required. For example, limited change to the tax model, few operational changes and no significant increase to reporting requirements will generally require only minimal IT change in terms of system setup, data migration and governance or integration of systems. On the other hand, where an LEM project gives rise to more extensive organizational change, new reporting requirements and so on, the implications for IT will be more profound and need to be reflected in a business case. In addition, making sure that LEM projects and IT are considered together can realize valuable synergies. An ERP implementation, for example, will share some of the common drivers of an LEM project, such as data migration and system integration, and can deliver benefits, provided that due upfront consideration is given to both projects.

**Tax**

Tax is a key consideration and driver of LEM projects. But in building a business case, there are two distinct areas of savings that need to be take into account: quantifiable and unquantifiable upfront savings and tax cost savings arising during the process of the LEM project.

The first type of savings are the “hard cost” savings. With fewer operating entities, there is a lower requirement for tax documentation and less support required. Our estimates suggest that savings can be between £4,000–£10,000 (€5,000–€12,600) on average per entity, per year. In addition to these cash savings are the (less quantifiable) reductions in management time required to deal with compliance, a saving of time that can be repurposed into more strategic, value-adding work. Those human capital costs are all too often overlooked in the development of a business case.

In addition, are some even less quantifiable benefits that may, in fact, achieve greater benefits. These fall into three areas:

- Updated historical tax structures
- Responding to corporate governance requirements
- Aligning tax structures with the business model

Many groups face both internal and public governance and regulatory pressures to reassess the structures they may have had in place for historic tax planning purposes. These structures have come under increasing scrutiny on an EU-wide basis. We’re therefore increasingly seeing transparency as a key driver in decision-making about tax strategy, with LEM projects playing role in delivering to these new demands.

The OECD’s base erosion profit shifting (BEPS) project will impact on all international groups, particularly with regards to country-by-country standardized reporting. Aside from the costs of setting up the relevant reporting mechanisms, there is also a danger that, in the absence of entity rationalization and simplification, information reported may be misinterpreted and subject to challenge. This could lead to additional work, and therefore cost, for the tax function. An LEM project can usefully serve to reduce group complexity and limit the additional administration that BEPS will require.

The second category of tax savings will be those that only materialize once an LEM project is in progress. These are frequently overlooked when creating a business case for an LEM project, but EY’s experience suggests that they are often sources of considerable value. Examples include the use of loss carry-forwards; overhauling an existing finance structure; optimizing operating model effectiveness; removing historical layers of taxation that have given rise to inefficient intragroup payment and transactions; and optimizing the group’s intellectual property holding structure.
Finance and accounting

Traditionally, the focus of benefits arising from LEM within accounting and finance has largely been on the available reduction in direct costs. However, EY’s experience suggests that these cash costs make up only a small proportion of available benefits and ignore the wider organizational improvements arising from better managing key risks.

One of the main benefits from LEM is the ability to address and reduce complexity within an organization. Transactions and balances between companies, for example, intercompany balances, can absorb significant amounts of management time. A high volume of transactions between entities can increase the risk of unreconciled payments and balances that may increase the chances of fraud and error.

In one such example, EY advised a large multinational to help prepare it for a major transaction. Our work uncovered significant lack of control and oversight of a large number of entities, which meant transactions and intragroup balances had not been effectively documented, controlled or reconciled. The result was the discovery of significant tax underpayments that required considerable time to resolve with the appropriate revenue authorities in order to minimize the imposition of penalties.

LEM can play a key role in controlling complexity and limiting its adverse consequences. A further, and often disregarded, benefit from reduced complexity is the saving of management time. This comprises not just the direct time required in preparing and reviewing accounts, and related activities, but also the opportunity costs arising from tying up those resources. One way to capture those costs may be to assign a “charge-out rate” to different grades of management in order to try and crystallize the benefits.

The characteristics of driving a successful business case

While all LEM projects will reflect the nature of each organization and its specific goals, our experience suggests that successful LEM projects share a number of key characteristics in the way that they are agreed and promoted with all relevant stakeholders, including senior management.

We typically see a number of activities as being important in building and communicating a business case:

► Invest in the time needed to align stakeholders* to create a shared understanding of the project’s goals and the activities required to achieve them
► Ensure there is clear, two-way communication with the stakeholders – we recommend making calls and holding meetings regularly, from the start and throughout the project
► Operate with a step plan that includes quick wins, which will help kick start the project and generate momentum toward its successful conclusion
► Articulate and communicate the planned and realized benefits carefully to maintain momentum
► Track the benefits achieved and celebrate success as the program proceeds

*Stakeholders include tax, accounting, finance, treasury, legal, business and IT
Note: the contents of this document are intended to provide general explanations of legal entity elimination processes and related procedures. They do not constitute advice and are not instructions for carrying out these processes and procedures, and therefore should not be used as a guide to doing so. Professional advice should always be sought for these purposes.
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EYG No. DE0586
1492425.indd (UK) 02/15. Artwork by Creative Services Group Design.
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