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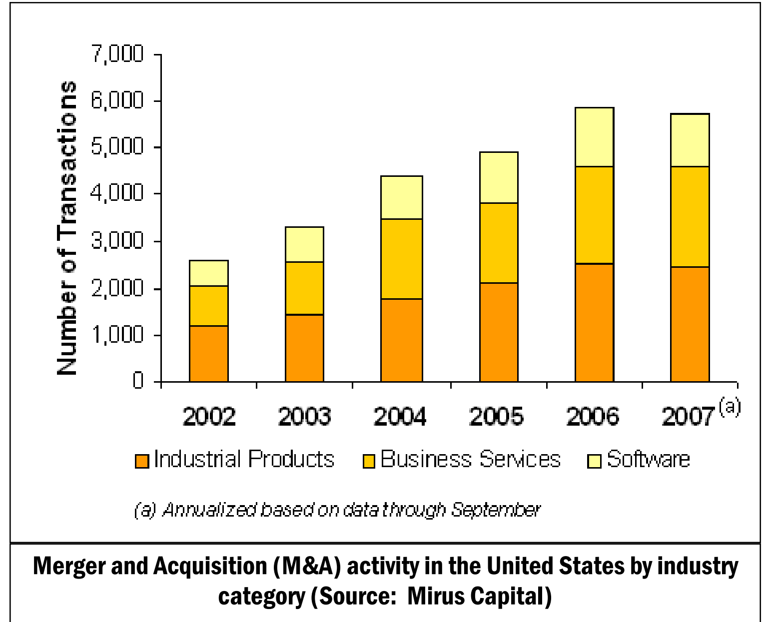
Assisting Acquisitions and Divestitures through IT Cost Transparency

Few businesses are made up of easily separable parts, yet the working fiction between buyers and sellers of corporations or divisions is that they are. In fact, very few businesses document their information technology environments clearly and comprehensively enough to support a reasonable separation process. The "deal team" responsible for getting the parties to agree on terms is usually far removed from the hidden costs and complicated IT issues that every merger creates. As a result, for CIOs and other IT executives, acquisitions and divestitures present unaccustomed challenges that place tremendous stress on their organizations.



Merger and Acquisition (M&A) activity in the United States by industry category (Source: Mirus Capital)

Four Types of M&A-driven IT Costs to Consider

There are five important types of costs that corporate deal teams often fail to consider fully:

- Costs of splitting or integration for applications, infrastructure and data
- Third-party contract penalties
- One-time or additional support costs
- Unabsorbed (or under-absorbed) overhead
- Transition services costs

Even when an effort is made to fully account for these kinds of costs, they are usually underestimated. As a result, unexpected costs often burden CIOs and others responsible for newly structured entities.

Given the pace at which M&A activity takes place, and the likelihood that any given IT department will experience some kind of structural corporate change during the tenure of its current management team, it makes sense to plan for these disruptive changes. This paper will explain how forward-looking IT departments can take steps to make their costs and relationships transparent. By so doing, they will be able to perform a service to their present (and future) organizations when change comes.

Contractual Costs of Splitting or Integration

In a typical multidivisional company, divested/acquired entities have hardware and software assets that:

- Belong to them alone (if they are a legal entity rather than a business unit) and are used by them alone
- Belong to them (as a legal entity) and are used by another division or other legal entity in the corporate group
- Belong to the immediate parent/ultimate parent corporation or to the corporate center and are delivered to them and the rest of the entire corporation as a service
- Belong to another business unit/entity (and may or may not be permissibly used by the division/entity to be divested)
- Are contracted under a transition services agreement with a previously related entity

- Don't belong to anyone (*i.e.*, acquired through "unofficial" software license proliferation).

These same entities consume services that:

- Are contracted directly to them and used by them alone, or also used by other divisions
- Are contracted with the parent corporation or the corporate center
- Are contracted with another business unit (and may or may not permissibly be used by the division to be divested)
- Are beyond those contracted anywhere in the company.

While untangling this snarl of rights and sorting out the resultant costs, the real world always presents additional complications. Consider these:

- The cost of new licenses when the entity sale agreement specifies to the buyer that one copy of software title *X* is provided for every employee (or every desktop) that is in the scope of the sale, and the entity being divested always believed that its payments to the corporate center included the receipt of a fully maintained copy of that software for everyone in the division — but it did not
- The cost of obtaining consent for allowing the divested entity (now a third party) to continue using a software product for a period of time following the date of the formal sale (while it transitions to the product the buyer uses for the given function)
- The cost of buying new free-standing infrastructure to support applications currently being run on a shared infrastructure
- The cost involved in extending the current license grant to include delivery of the software via a transition services agreement to the divested entity following the date of sale

- The cost of enhanced security for data separation to wall off a third party
- The cost increase for IT services to all other divisions because the loss of the entity being divested takes service volumes below the minimum RRC structure of an outsourcing agreement, triggering an "extraordinary event" and a price renegotiation with the outsourcer.

These IT costs are often unknown until discovered in due diligence, further defined via internal discussions, and finally scoped and understood only after detailed dialogue and negotiations with suppliers have occurred months into the project and uncomfortably close to, or even after, the transaction closing date.

One-Time or Additional Support Costs

While the burden is on the selling company to provide a clean and unencumbered set of assets to the buyer, the contractual issues on the buying side involve discovering everything about the new environment and carrying the run rate cost of supporting it until it can be integrated.

Until integration is complete, the buyer will have additional variation/complexity introduced into his environment through the necessity of managing multiple standards/ additional suppliers.

These contractual issues often involve significant unanticipated costs:

- The cost of having to renew the maintenance agreement for the acquired company's legacy systems for an additional period of time because of delays in the conversion project
- The support cost of dealing with products/applications of the seller that have fallen out

of normal support and have to be maintained under special and costly support arrangements with the publisher

- The one-time costs associated with delayed data center moves, mainframe consolidation, or application re-platforming, if critical path application remediation takes longer than expected
- The governance and management costs of delivering and receiving services under a transition services agreement.

Unabsorbed (or under-absorbed) Overhead

If it is axiomatic that overhead can never be made precisely proportional to consumption in a stable organization with no M&A complexities, then imagine the inequities that arise when companies are added or subtracted mid-stream. Unabsorbed overhead (any indirect cost that cannot be apportioned to a surviving business) and under-absorbed overhead (any difference between overhead cost incurred and overhead cost absorbed) are a common result of M&A activities.

Consider these examples:

- Two years ago, the corporate center acquired a new mainframe based on the growth requirements of the entity now being divested. This may have been depreciated over five years. The divested entity moves into the data center (or under the outsourcing agreement) of the buyer and has no more need of the selling company's mainframe.
- The corporate center acquired an enterprise agreement for a general ledger package, and the divesting entity is moving to the buyer's GL system and no longer has need of the licenses. The "loss of scale" for the seller makes the enterprise level commitment no longer worthwhile.

- The corporate center entered into a multiyear commitment for disaster recovery services for the entity to be divested, and the entity refuses assignment of its portion of the agreement because it found a cheaper local alternative or was added to an existing relationship
- The entity being divested, because of future growth plans, had agreed to take a disproportionate share of overhead for a new data center buildout, and, now that it's being sold, wants its money back.

Minimizing the impacts of unabsorbed overhead and creating appropriate management expectations

To minimize the impacts and plan for the accounting results of M&A activity, ask the following questions:

- How will any excess or surplus overhead be reconciled in a way that can be anticipated and that is fair both to the buying/selling entity and to the entity being sold/acquired?
- Are there formal intercompany agreements in place that don't involve cross-subsidizations and that clarify the cost of exit?
- Do any surviving businesses have government or other cost-based (*e.g.*, cost plus) agreements in place which restrict the ability to change rates?
- Both buyers and sellers need a realistic model or plan to identify and deal with the overhead associated with the transaction, namely:
    - For sellers: The overhead that will not go away as the result of the divestiture
    - For buyers: The overhead that will be added through the acquisition.

Transition Services Costs

Given all of the above and the frequent disconnect between the dealmakers and those responsible for IT implementation, is it any surprise that transition services fees sometimes fail to account for all appropriate IT costs?

All of the above complexities apply to transition services agreements and the costs they allocate, plus a few more. For example, a transition services agreement's requirement for data separation during the transition period might force the selling company to buy new hardware. What becomes of this stranded asset at the end of the transition period?

Creating IT Cost Transparency in Anticipation of Organizational Change

The best preparation for supporting acquisitions/divestitures (and one with many associated business benefits) is to achieve IT cost transparency by putting one's house in order ahead of time and choosing to run IT as a business.

This is an idea encountered commonly enough at conferences and in journals, but here we are referring to implementation of a specific set of roles, tools and functions.

For sellers, this means making the financial terms of all intra-company relationships as explicit as though they were third-party agreements. Acting as the equivalent of an external service provider will support due diligence, cost treatments and the organization of the required separation activities.

For buyers, the creation of an ad hoc IT offerings catalog is an excellent expedient for collecting and organizing information about the entity to be acquired.

The IT offerings catalog is the perfect tool for any organization that wants to achieve the kind of cost transparency that will help assure smooth corporate change. While there are many simple consumption-based IT offerings catalog models available, true cost transparency can only be achieved with an offerings catalog that includes the identification and definition of:

- Services
- Metrics of consumption/charges and minimum increments
- The asset and third-party contract components of services
- Clear definitions of what is in and what is out of scope of the services
- Service levels
- Rate true ups/reconciliations
- Apportionment of overhead; and
- Costs of exit

IT Offerings Catalog Examples

Rate-Based Bundled Transaction

Service: Claims Service – Check Processed	**Service Code:** 6024
Service Manager: Jane Smith	Phone Number: (312) 888-4676
Billing Contact: Larry Jones	Phone Number: (312) 888-2822

Service Usage Ledger Account: 6506024
Service Material/Pass-Through Ledger Account: N/A

Description of Service:
All maintenance and production support activities required to support the backend processing including all claims posted to the financial systems via the following: TPA Process, First Claims Close, Second Claims Close, Deductible Processing Applications, CIMS Flat Files Processing, and Business Objects for CIMS Oracle.
Service Expectation:
- Full service normal business hours, on-call 7x24

Rate: $0.075	Minimum Charge: 1 Transaction	Minimum Increment: 1 Claim Suffix
Usage Unit: Audit Transaction	Co-requisite Services: None	Cost Transfer Method: Purchased

Billing and Administrative Guidelines:
Charges are based per actual transaction on second close audit file - No exceptions
Actual check count from the prior month will be billed in the current month
Components of this service cannot be purchased separately.
Use of any portion of the service will result in payment of the full rate

Additional Tasks and Vendor Charges Associated with this Service (not all inclusive):
- All maintenance and production support activities required to keep the backend processing components in production.
- Systems inquiries, System monitoring, System re-run & recoveries, Balancing and controls, Statutory changes, Infrastructure changes, Vendor upgrades, Regression testing, IMPS processing, Disaster recovery
- Machine and operations charges related to the running of the Claims backend process including printing, fiche, DASD, CPU, etc.
- Coordination with downstream systems for related changes
- Statutory changes up to 2 FTEs across Service 022, 023, and 024

Tasks and Vendor Charges NOT Associated with this Service (not all inclusive):
- Charges for Claim Adjuster Desktop, Colossus, & Mira, CIMS Oracle database and the Corporate Systems TPA systems - Paid and performed by customer.
- Enhancement or development work - Included in service 025
- Statutory changes greater than 2 FTEs across Services 022, 023, and 024

Budgeting Guidelines:
This service is comparable to ITD service Claims Service - Non Claim Database Usage (024) in 2000
Estimate the total number of usage units you anticipate requiring of this service.
This information is available in service ledger account 6506500 for your cost center. Look in the JV line description for the 2000 service(s) mentioned above.
Enter the estimated number of units as usage in the Service Usage Ledger Account of your budget workbook.

Pass-Through Service

Service: Field Office Telecom Allocation Pass-Through	**Service Code:** 6044
Service Manager: Alain Senderens	Phone Number: (555) 822-7779
Billing Contact: Pierre Gagnaire	Phone Number: (555) 822-7779

Service Usage Ledger Account: N/A
Service Material/Pass-Through Ledger Account: 6526044

Description of Service:
Local and long distance field office telecommunications in field sites
Service Expectation:
N/A

Rate: N/A	Minimum Charge: Actual Charges	Minimum Increment: Actual Charges
Usage Unit: N/A	Co-requisite Services: 10	Cost Transfer Method: Purchased

Billing and Administrative Guidelines:
All non-cost center specific local and long distance, and shared 800 service charges are identified by location, then this total is allocated based on headcount by location.
Location headcount data update from HR data warehouse
Pass-throughs include vendor invoices only.
Charges are passed to the customer in the period in which the invoice is paid.
Charges may lag past service termination based on the vendor billing cycle.

Additional Tasks and Vendor Charges Associated with this Service (not all inclusive):
- Field Local and long distance service / usage charges.
- Non-cost center specific 800 services.

Tasks and Vendor Charges NOT Associated with this Service (not all inclusive):
- Field voice mail service - Included in ITD Service Code 010.
- Telephone equipment moves, adds, and changes - Included in ITD Service Code 045.
- Cost-center specific 800 service - Included in ITD Service Code 045.
- ISDN lines - Included in ITD Service Code 045.
- Voice, Data and Video conferencing - Included in ITD Service Code 045.
- Cost center specifc fax and pager usage - Included in ITD Service code 045.
- Cellular telephone, calling card usage - Not provided by ITD
- Telephone and voice mail system maintenance and depreciation expenses - Included in Service 010.
- Invoice review and processing - Included in Service 055
- Vendor Management - Included in Service 055

Budgeting Guidelines:
This service is comparable to ITD service Field Office Telecom Allocation Pass-Through (044) in 2000
Estimate the total dollar amount you anticipate requiring of this service.
This information is available in service ledger account 6526510 for your cost center. Look in the JV line description for the 2000 service(s) mentioned above..
Enter the estimated dollar amount in the Service Dollar Ledger Account of your budget workbook.

Rate-Based IT Component

Service: Laser Print Data Center	**Service Code:** 6071
Service Manager: Robert Serber	Phone Number: (555) 822-2486
Billing Contact: I.I. Rabi	Phone Number: (555) 822-2822

Service Usage Ledger Account: 6506071
Service Material/Pass-Through Ledger Account: N/A

Description of Service:
- Includes production, operation and distribution of laser print at the Home Office Print Center
Service Expectation:
- On time report delivery 99.90% of the time based on annualy negotiated delivery times; Class "I" production output in the output queues by 4:00 AM will be available in the distribution bins by 4:00 PM, Class "O" test output will be processed after production work is completed. Special delivery and mailing agreements have been made between the Print Service manager and some application areas. These agreements are renegotiated annually with our current goal of meeting on-time delivery of these reports 99.90% on schedule.

Rate: $0.022	Minimum Charge: 1 Printed side	Minimum Increment: 1 Printed side
Usage Unit: Printed Side (Image)	Co-requisite Services: 066, 067, 080	Cost Transfer Method: Purchased

Billing and Administrative Guidelines:
- Print Services Manager contacts business customers in the 4th quarter for delivery times in the following year, or at the time of new service initiation; Billings records are logged via System Management Facility (SMF) records and are read by the Cost Recovery System monthly; Non-mainframe generated print is billed through non-SMF records (e.g., UNIX and NT);
- This service is initiated by programmers writing reports and specifying appropriate Job Control Language (JCL) parameters directing print output to data center laser printers.
- Components of this service cannot be purchased separately. Use of any portion of the service will result in payment of the full rate.

Additional Tasks and Vendor Charges Associated with this Service (not all inclusive):
- All output will be on cut sheet paper; Maintenance - Xerox Operating System Software & Resource Management; Hardware and software management; Production Support - Problem solving production jobs; Facilities Planning - Equipment installs or restacks-Equipment Planning - Based upon capacity or SBU Functional Requirements; Technical Planning - R&D in support of SBU requirements or long term needs; Performance Management - Monitor applications to ensure maximum printer throughput; Capacity Management - Monitor print window and needs capacity; Operations - Includes set-up, printing and distribution of output; Scheduling; Limited technical consulting - Product Suppor; Operations support activities and associated costs are provided under this service but the activity details are described in Appendix 2; Maintenance for hardware, software, consumables, 20 lb plain-white standard paper.

Tasks and Vendor Charges NOT Associated with this Service (not all inclusive):
- Charges for Data Center CPU, DASD, or Tape - Included in ITD Service codes 066 or 067, 77, 78; DocuMerge Support - Provide consultative support for electronic document creation and packaging - Included in ITD Service Code 036; Electronic Form/Font Support - Consulting with developer/outsource vendor on format & turnaround requirements - Included in ITD Service Codes 36 and 99; Consulting services to support new or modified applications or forms - Included in ITD Service Codes 36 and 99; Purchase, storage and shipment of forms and supplies - Paid directly by customer; Special paper and forms - Paid directly by customer.

Budgeting Guidelines:
This service is comparable to ITD service Laser Print Data Center (071) in 2000.
Estimate the total number of usage units you anticipate requiring of this service;This information is available in service ledger account 6506500 for your cost center. Look in the JV line description for the 2000 service(s) mentioned above. Enter the estimated number of units as usage in the Service Usage Ledger Account of your budget workbook.

Beyond Transparency Tools: The Planning and Projects Necessary to Support Acquisitions and Divestitures

Having an IT offerings catalog (and all related processes and roles) is an excellent preparation for orderly transactions. It simplifies the process, necessarily creates better asset records and supports transparency of IT costs. However, a whole set of additional activities will have to be engaged ad hoc to support actual divestitures/acquisitions.

The thoughtful execution of the activities described over the next several pages is the necessary additional work required to surface, identify and control IT costs associated with transactions.

Opportunities afforded by an informed due diligence process

Many organizations have lived with decentralized procurement and sourcing with little or no formal contract management — because they could. The first step to fixing this situation is often an all-points bulletin to the organization to collect the relevant agreements and to populate a common template to organize them. Since software agreements are the most scope-sensitive contracts, this is the area of greatest exposure to hidden costs.

Knowledge of the contractual areas from which costs arise should guide the way in which agreements are organized:

- Scope limitations (site, platform, capacity/quantity, license metric)
- Usage restrictions (asset ownership, internal business use only, use only by employees, use in service bureau environment prohibited, use by third parties expressly forbidden without written consent, *etc*.)
- Transfer restrictions.

The administrative "heavy lifting" in this process is contacting one's entire affected

portfolio of suppliers and resolving each unique software consent issue.

When proceeding through the due diligence/discovery process, consider timing contacts with suppliers around divestiture and acquisition issues to synch with other planned transactions. For example, mainframe consolidation can provide an opportunity to re-architect logical partitions for the new combined workload to rationalize license costs. The due diligence information received can quickly identify "dinosaur" platforms that will be targets for elimination/re-platforming.

Many of the costs of divestiture arise from the need to use products and services in ways that go beyond the terms of the agreement the parties entered into originally. Additional copies of software are sometimes needed to address "discovered" compliance issues that arise because of separation. Thorough investigation of current actual use in an organization and the recapture of excess licenses can minimize the transaction cost (Can unmaintained copies of the software in inventory be provided instead?). One can negotiate non-punitive pricing (vendors often require acknowledged compliance purchases to be made at full list price) and combine with other transactions or commitments to produce discounts. To minimize the effect of assignment fees (some vendors view partial assignments as a foregone sale to the new entity and want to charge a whole new license fee), one can model the transaction for the supplier as an event of "net zero additional use" and work with the new entity to see if they are amenable to making a multiyear support commitment in exchange for avoiding a punitive assignment fee.

Transition Services Agreements

Designing the Transition Services Agreement

Developing sound transition service agreements is a key element of defining and planning integration/separation activities.

Transition service agreements are made simpler if there is an existing IT offerings

catalog that spells out the terms of use of company services.

The transition services agreement input should help address the following questions:

- What set of services will the divested entity need (for the buyer, what services will be needed until the acquired entity can be fully integrated)?
- How long will each of the services be needed?
- What if, in any individual case, the services are needed longer than planned? Will this interfere with plans to return an asset, end a lease or reallocate a resource? Will delays cause a ripple effect through the organization?
- What if services are needed for less time than planned? Will this create stranded assets?
- How will "in-flight" projects be treated?
- How will one reallocate the IT PMO staff no longer needed to support the divested entity?
- What are the requirements in the sale agreement for data separation? Will this require acquiring a temporary parallel infrastructure that may not be taken by the divested entity?

Keys to success in creating a functional transition services agreement:

1. Know the deal team:

   Know who the "deal team" is and understand the commitments they have made in the sale/purchase agreement that will bind one to a service provider or that one is entitled to benefit from as a service recipient. Get representation on the deal team to help guide the decisions that haven't already been made.

2. Create a clear agreement:

   Create a clear agreement that conforms with the commitments made in the sale/

purchase agreement and that provides IT offerings catalog-like clarity in terms of:

- Service definitions (clear definitions of what is in and what is out of scope of the services)
- Co-requisite services
- Metrics for consumption
- Service levels
- Charges and minimum increments
- Planned duration of each individual service and the financial consequences of exiting the service earlier or later than planned
- Tracking and true-up mechanisms for service usage at levels other than as planned
- Rate-based versus pass-through charges
- Governance and reporting expectations
- Change processes.

3. Roles:

Establish a governance organization to manage the transition with the following general roles filled as appropriate for both the buying and selling organizations:

- Executive committee (both buyer and seller) to provide oversight/escalation
- IT finance/budget management (both buyer and seller) for pricing and payment
- Project Management Office (both buyer and seller) to keep the transition on track
- Individual service owners (seller) to take primary responsibility for service delivery
- CRM (Customer Relationship Manager) (buyer) to represent requirements

of the buyer

- Other cross-functional services roles (seller):
  - Incident and problem management/resolution (including root cause analysis)
  - Change management process
  - Other connecting operational processes (*e.g.*, management of downtime, upgrades, *etc.*).

4. Expected duration is a key consideration:
   - Transitions of short duration (*e.g.*, three months) can be supported by agreements that assume uniform service definitions
   - There is a lesser requirement for cross-functional roles to administer change during a brief transition
   - Transitions of longer duration (*e.g.*, six months or longer) are more likely to encounter pressure for changes in services definitions arising from changes in buyer requirements or by crossing a budget year boundary during which the seller may also be redefining or re-pricing services. Therefore:
     - A comprehensive change management function will have to be part of the cross-functional organization that supports long duration transitions that include operational, service definition and pricing changes.

Conclusion

Revealing, defining and formalizing an organization's IT costs via robust mechanisms such as IT offerings catalogs can better prepare organizations to support mergers/acquisitions and can even influence deal team decisions regarding the negotiation of transition arrangements.

Early interactions with the deal team can aid understanding of the commitments that have already been made and provide an opportunity to exert a practical influence on any deal terms that are still malleable.

Additional contract and IT analysis, aided by expert awareness of cost issues, will help reveal all cost issues for a successful transaction and aid in the preparation of a well-crafted and well-managed transition service agreement.

The use of IT cost transparency tools, contract analysis, and the development and management of thoughtful transition agreements will result in transactions that are hampered with fewer unexpected costs, will leverage savings opportunities, and will meet the expectations of management, analysts and shareholders.

Contact

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About Swingtide

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