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Accounting for Knowledge in Mergers and Acquisitions

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Knowledge is central to the success or failure of a merger or acquisition. The value of many organizations is today based on potential future earnings rather than tangible property or operations. Assumptions about an organization's knowledge, except perhaps intellectual property, and then not in its entirety, often get pushed off, or not addressed at all.

This Practice Insight will provide guidance on how to address knowledge during the four phases of a merger or acquisition in order to ensure a successful transition, the optimal leverage of combined assets, the unleashing of innovation during the process, and that important knowledge in the form of systems, procedures, social and human capital are retained and made available to the new organization.

Analysis

In the quest for valuation, proactive knowledge due diligence is often neglected. Knowledge can be a key factor in the success or failure of a merger or acquisition. While products and balance sheets may appear complementary or of greater value combinatorially, the failure to understand who an organization is, its unique approach to work, the technology and platforms it has chosen to deploy, and how it learns, can negate any gains that were derived simply from financial or portfolio considerations.

Good mergers and acquisitions require a recognition of the value of knowledge, and well executed ones need dedicated due diligence aimed at ascertaining the knowledge of an organization as represented in intellectual property and in knowledge intangibles. Many of the intangibles reside inside the people of the organization, and the failure to recognize how knowledge manifests in an organization can lead to gaps that will prove expensive to bridge if key staff leave of their own volition, or worse, are released as part of the deal.

Process Considerations

Although financial processes may not directly align, regulations and accounting practices usually allow finance teams to reconcile accounts. Certainly the money itself easily finds its way into whatever coffer wins the day. Unless the intention is to inorganically create a conglomerate or develop a holding company portfolio, products and services are also usually easy to reconcile, even if overlap exists.

The knowledge of the organization, explicit, implicit and tacit, however, is often less aligned — and in many ways, nearly impossible to discover during the due diligence phase of a merger or acquisition. How communications take place, the product development process and the networks that facilitate informal learning often prove vastly more important to the success of a merger or acquisition than the complementarity of products or services. Even if the intent is to allow the purchaser's processes to replace those of the acquired, the replacement must still be negotiated, and it is highly likely that the negotiation will reveal something of value from the systems of the acquired company that will modify the systems of the purchaser, even in the implementation of the processes outside of the integration points.

It is better then, to look at the merger or acquisition as an opportunity to reflect and optimize, bringing together the best aspects of processes, and, while the opportunity exists, to eliminate annoying steps in both. In many organizations today, these process changes may also require changes to transaction or workflow systems that automate some or all of the processes.

While processes and their supporting technology are the most explicit and codified forms of knowledge, that does not imply that they are all easily discovered or well documented. The translation of a process into automation codifies it, often locking in an way of doing something that creates an assumption about the process. The process then has a "life of its own" without benefit of curation, challenge or reflection. Those working through knowledge due diligence need to understand that process obfuscation is fairly common and it can make displacing existing processes difficult.

If codified knowledge in the form of processes can create issues, then other types of knowledge prove even more intractable until organizations merge and are forced to confront different approaches to how things are done, or how data is interpreted.

A merger or acquisition is as much a knowledge management investment as a financial or strategic one. In fact, failure to recognize the importance of knowledge, adequately account for it, and to effectively integrate and leverage it may weigh on the ability to create value from financial or strategic synergies.

It is incumbent upon those involved in due diligence that they actively and aggressively seek to understand the knowledge components related to the target firm, or to the synergies between two or more firms in a merger.

The remainder of this Practice Insight focuses on the types of knowledge that should be examined in each phase of a merger or acquisition, and those that cross phase boundaries.

from designs and process knowledge, to copyrights and licenses.

While a pre-deal desire to understand a company's culture may exist, the abstraction of culture makes it relatively difficult to do so when compared to examination of a company's financial position. Proxies, however, can be examined that provide insight into the "culture" of an organization. Key practices, how space is used, what transaction and collaboration environments have been implemented, and feedback loops on actions are excellent proxies that reflect the value placed on learning and the ability to adapt effectively to emergent situations. Looking at the learning environment itself, including on-boarding, professional development and capturing lessons learned from retiring employees, offers additional insights. It is important to look not just at curriculum, but implementation, most importantly, how learners and managers measure success.

Managers seeking to monitor the progress of a merger or acquisition can look to these learning measures to determine if engagement and learning have continued, accelerated or decreased as a result of a merger or acquisition. The successful adoption of new or transition material will be particularly telling.

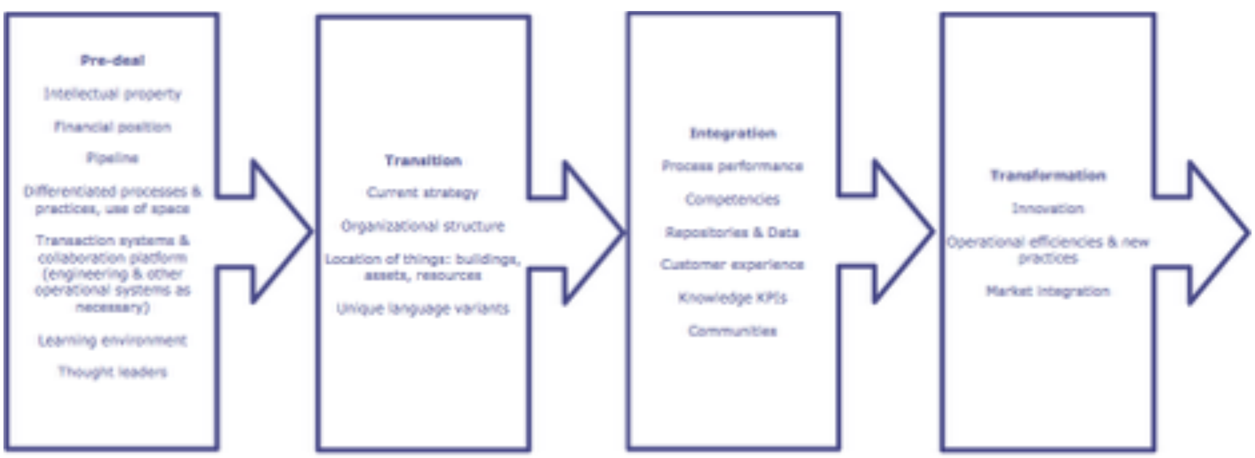

Figure 1: Knowledge Impact Across Four Phases of a Merger or Acquisition

Knowledge & The Four Phases

Figure 1 illustrates the four phases of a merger or acquisition: pre-deal, transition, integration and transformation. Each phase requires its own contextual knowledge that must be addressed during that phase of the merger or acquisition.

Pre-deal

Pre-deal knowledge due diligence must include an understanding of all aspects of intellectual property,

Those leading the merger or acquisition teams need to seek out and document unique knowledge and experiences, including the identification of key employees who possess knowledge, including social capital, that may be difficult to replace. Strategies to retain key talent should be formulated early.

Transition

The transition phase places an emphasis on understanding and aligning the strategies of the organizations involved. As part of this, they must also understand their competitive advantage, including how each is currently organized and where assets are deployed. Proactive knowledge management during transition should include building a consensus context to create a shared language and belief system (see "Create a consensus context" below) and rapidly deploying a transition collaboration environment that spans the merging organizations, enabling the team to work in a geographically dispersed manner without tackling the often lengthy task of collaboration systems integration.

Integration

During the integration phase, the organizations must begin to act in concert. From the knowledge perspective, this includes the integration of process knowledge, both manual and automated (as embodied in workflow and applications), competency mapping to determine who knows what and where they are, and the deployment of sense and response to monitor the new competitive landscape. At this point, the organization should also integrate its repositories and intranets and choose a strategic collaboration environment that will facilitate feedback loops and enable the combined organization to move beyond operations to innovation. Once the competency mapping is complete, identified communities of practice should seek affinities and merge their activities. This is also the time to review or develop new metrics that will define the tracking mechanisms of the firm to see if it is achieving its knowledge expansion and retention goals.

The integration phase of the merger and acquisition process should arrive at updated competencies, new key performance indicators for knowledge work, integrated communities, and rationalized data repositories and schema.

Transformation

Some examinations of mergers and acquisitions call this phase leverage, but it is more aptly characterized by transformation. Not only are the two entities now leveraging their shared knowledge and assets to create new value, they have actually become a different organization after integration than they were before. This is true regardless of which side of the deal asserts more control. The entity extant after implementation is essentially a new organization—even if it doesn't feel like one; it is valuable to think of it as different than any of the organizations in the deal.

Transformation should also seek to benefit from a deeper understanding of the design elements of the organization, its policies and practices, space and technology, as well as its people. Leveraging the new elements of the organization leads not just to innovation opportunities, but also to operational efficiencies. Sometimes operational efficiencies should wait for this later gestation, lest they disrupt important work that may not yet be understood by the new owners, or the merged management team. New value emerges during transformation which requires that managers openly and vigilantly assess and test new ideas.

It is in this last phase that organizations also seek market integration if they have seemingly disparate product or services lines that don't, on their surface, make sense together. A merger or acquisition is an opportunity to create a new context and bring with it relationships between concepts that may not have existed before. Strategically, this may ultimately realize the market opportunity of items competitive in their own spaces, as well as defining emergent markets. That conceptual redefinition is a highly knowledge-intensive activity that essentially creates a new chapter in the story of the organization.

Seven Cross-Phase Knowledge Elements to Consider

Beyond the four phases, there are seven cross-phase knowledge elements that consistently prove important to the success of a merger or acquisition. Each of them should be accounted for within and between phases.

1. Create a consensus context

When most organizations talk of "culture" they do so referring to the set of practices, data, beliefs and behaviors that constitute their way of doing things. Unfortunately, most organizations don't actively document their culture. During a merger or acquisition, how the organizations fit together becomes an intuitive exercise by executives with limited input from other leaders involved in the project.

As organizations enter into a non-organic growth decision, it would be wise for them to look at their own organization as though they were new employees. It can take a new employee six months to internalize jargon and concepts, acronyms and practices. Organizations thinking about blending with another should aggressively seek to understand their "culture" in the most non-abstract ways possible, so they can not only assess fit well, but also facilitate transition.

Target firms, of course, don't have the foresight to undertake a formal recognition of their culture, but the purchaser can make the transition smoother by sharing their worldview. At least the target firm will have rich content to describe comparisons and contrasts.

2. Rhythm & motion in M&A

The book Management by Design, suggests that organizations seek alignment so that all work clearly and transparently rolls up to top-level strategy. In merger and acquisition activity, this means articulating, and communicating, the strategic importance of the merger or acquisition. The M&A activity is the work in this case that must align with strategy.

Those involved in a merger or acquisition should be able to define the reason behind it. The following list outlines the primary reasons behind a merger or acquisition.

- To reduce costs
- To expand market share
- To improve service delivery
- To eliminate competition
- To enhance customer service capabilities
- To obtain new technology
- To obtain new skills or intellectual property

Each answer offers its own set of priorities for action, but when looking at the activity from a knowledge perspective, the ability to fit organizations together extends well beyond the singular purpose of the merger or acquisition.

Being able to articulate and understand "why" acts as an internal litmus test upon which trust and subsequent work toward integration lies. A poor answer to "why" raises its own questions about the efficacy of proceeding.

The answer to "why" must be visible throughout all communications regarding the merger or acquisition. All actions, assignments and metrics should align with the "why" and not conflict with it, and even better, clearly reinforce it.

3. Make knowledge explicit

While a consensus context creates a common intellectual framework, working to make knowledge explicit is also a task that will help the transition take place smoothly. Knowledge too is about fit, but it is also about duplication and alignment. Processes, products and services from each side of a deal have a unique history, and therefore, regardless of how much outcome of a process, product or service appears to be the same across company, its evolutionary heritage makes it something different.

Think about a bat and a bird. While gliding at a distance, a bat and a bird appear to be similar animals that can fly. Up close, and inside, the two animals reflect greatly different heritages that have converged on a similar set of external traits that allow them to fly. The adaptations, however, are vastly different.

Organizations on both sides of the deal need to share or discover the uniqueness of their approach to the world, which has become their knowledge base. They know how to process a customer return. They know how to launch a new product. So does the company on the other side of the deal. The truth is what they know is uniquely contextual to the firm, and they need to expose the anatomy of what they know so they can map ways to use the best features to create the new entity.

4. An IT river runs through It

Information technology streams through every aspect of a deal. It is reasonable to think that if procedures and practices greatly diverge based on their evolutionary history, the IT systems that support them will likely diverge as well.

It is not, for instance, good enough to just say, "OK, we are both Microsoft shops," meaning they run Office, Lync, SharePoint and Exchange. If you look at something as seemingly ubiquitous as Microsoft Exchange, how e-mail servers are configured, the management rules associated with e-mail, and the actual way it is used by teams and individuals varies widely within a company, and even more so across organizations.

Any technology that can be configured or customized, regardless of its base configuration, is likely going to be divergent in implementation. Therefore, in mergers and acquisitions, paying attention to the knowledge behind how systems are configured, managed, deployed and run, can be a critical element in turning an expectation of a smooth integration into a much more contentious reality.

It is also important to identify the people responsible for maintaining unique elements of IT infrastructure. In mergers and acquisitions those people can become important allies, but also difficult stumbling blocks depending on their proclivity to adapt and assist, or undermine with intransigence.

5. Establish knowledge KPIs

Key performance indicators (KPIs) for knowledge-oriented issues should be established in the pre-deal phase and monitored throughout. These KPIs can also be used to compare the relative alignment of two firms on external factors like average education levels, mentoring ratios and general competencies. But like many knowledge elements, items like learning from customers, the approach to knowledge sharing or formally capturing lessons learned fall into the category of processes and practices with divergent approaches.

KPIs, however, provide an external metric for determining which is better than another. If customer satisfaction is high at one firm, and low at another, then it would make sense that customer service approaches and philosophies from the firm with better performing KPIs would be the right choice for retention. Don't just jump to that conclusion, however, look at the calculation models and data sources so that the numbers are understood, and the outcomes relevant in comparison.

Organizations should employ sense-and-respond feedback loops for their knowledge KPIs to facilitate learning. Knowledge KPIs aren't likely to be the purview of Big Data, but more likely very human: the ability to hear people whisper, and to understand weak signals coming through everything from enterprise social media environments, process feedback in meetings and sometimes not so hidden opinions in e-mail. This will allow organizations to quickly adapt to issues of design in implementation, or to the early identification of undesirable behavior before it becomes ingrained.

6. Taking the long view

Looking at the future value of an organization or a merger most often is extrapolated from a well articulated, but narrow, set of assumptions and constraints. A major factor is too often ignored during the due diligence process are the uncertainties faced by the industry, not just the company. This shortsightedness is usually endemic to both parties in the transaction. While there may be disagreements over the particulars of valuation, where the industry is heading creates a shared context for both organizations.

How an organization leverages foresight is a two-pronged knowledge proposition that combines forecasting knowledge with knowledge about key uncertainties and industry driving forces. There is valuable knowledge in understanding how the firm perceives the future, and the processes by which it analyzes and synthesizes insights in order to navigate change. Most organizations will not have invested in a foresight function, but if they have, it is critical to identify it early.

In an acquisition, it would be valuable for the purchaser to employ a set of long-term industry scenarios that reflect alternative futures so that assumptions generated by management can be systematically challenged, as can assertions about the future from the company being acquired.

7. Focus on people

Don't just start cutting staff. The new organization has no idea about the acquisition's capabilities and, therefore, may be eliminating staff members who could increase its own skill set or flexibility to deliver. Don't assume the best people for a job work for the acquiring company; take the time to describe requirements and find the best people to fill roles. The merger may also create an opportunity to radically change incentives or organizational models, leading to a more responsive firm. Also identify communities of practice (CoPs) and use them to ease the transition by converging on practice, rather than politics.

K.D. Johnston and P.W. Yetton outlined four major merger approaches: coexistence, absorption, best of breed and transformation (see Relevant Links and Other Sources). No matter which approach a company chooses, it will encounter impediments and opportunities based on knowledge. While the explicit recognition of knowledge issues appears to add additional work, the effort to leverage knowledge increases in cost as the project progresses. Wait too long and some opportunities may be lost forever. The loss of key employees, a customer dissuaded by poor quality or a plunge in profit margins indicate faltering knowledge processes. When high-level indicators flash red, organizations shift from seizing opportunities toward fixing problems. As manufacturing people know all too well, rework is always more expensive than doing it right the first time.

Merger and acquisition teams are responsible for the well being of large, diverse communities, often challenged by time and distance. By heeding the seven cross-phase knowledge components, they can help make the transition more effective, and empower adaptive behaviors in the new organization. Organizations should see mergers as an opportunity to leverage knowledge, engage communities in constructive and innovative dialog and explore new capabilities. If they ignore those opportunities, they will never again have the chance to stand on the edge of chaos generated by the merger and seize greatness through a new insight.

Recommendations

General

The success of any merger or acquisition relies as much on a solid foundation of knowledge and learning as it does on synergistic business models and complementary products.

Organizations must account for knowledge during the pre-deal phase, and treat knowledge as a key element of analysis and transition throughout the merger and acquisition process.

Organizations must understand the value and contribution of key employees (some of whom may take awhile to discover) and develop strategies for retaining them.

Regardless of origination of a deal, processes must be examined independently and negotiated to ensure the more mature process survives, or that the surviving process combines the best elements of two or more processes in an effective way that does not produce new complexities.

Phases

Pre-deal: Knowledge due diligence must include an understanding of all aspects of intellectual property, from designs and process knowledge, to copyrights and licenses.

Transition: Focus on creating a consensus reality that can be used to determine how well other knowledge fits, or doesn't, in later phases.

Integration: Organizations must act in concert in order to create an effective competitive advantage.

Transformation: Allow the organization to realize that it is a new entity and from this point on, while it may still be integrating some knowledge, it is time to start creating new knowledge.

Cross-phase knowledge elements

Successful mergers or acquisitions must include activities that address the following cross-phase knowledge elements.

1. **Consensus context:** Take the time to make create a consensus context so that the lead in the merger, or the acquiring firm, can more easily determine how well detailed knowledge elements align with existing systems and practices, as well as the investment that would be required to integrate less aligned areas, or to identify areas that should be adopted or discarded.

2. **Strategic alignment (Rhythm and Motion):** Agree as to why a merger is taking place and make sure that strategy and communications align consistently with the reason.

3. **Make knowledge explicit:** Account for the unique history of products, processes and services by documenting knowledge associated with them so as the transition occurs, it will be easy to compare incoming products, processes and services with existing ones.

4. **Account for IT:** IT is the hub of codified knowledge. Ensure that it is throughly inventoried, including knowing who knows what about what system in order to ensure maintenance and operational continuity, and leading eventually to smoother transitions of combined or new systems.

5. **Establish knowledge KPIs:** When it comes to knowledge, define measurements and describe what good looks like.

6. **Take the long view:** Discover and document uncertainties so that the consensus context acknowledges what it can't know. Consider scenarios to test assumptions about future states of the combined organization.

7. **Focus on people:** Understand the knowledge found in staff, partners and customers. Do not take this for granted; understand not only how to retain this knowledge, but also how to find value by leveraging it to achieve the merger or acquisition goals.

Relevant Links and Other Sources

"Integrating Information Technology Divisions in a Bank Merger: Fit, Compatibility and Models of Change," K.D. Johnston and P.W. Yetton, *Journal of Strategic Information Systems*, March 1996

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