FROM THE TRENCHES: COST CONSIDERATIONS OF OUTSOURCING

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INTRODUCTION

Outsourcing is a topic that can generate a lot of interpretation with respect to: lost jobs; issues in dealing with a person half way around the world that doesn't 'get it'; language barriers; shifting economies as companies move operations off-shore; and more. On the other hand, from an organization's perspective, outsourcing is an opportunity to scale capacities at a reduce rate of overall expenditure and improve their bottom line.

Whether you like it or not, in order for organizations to remain competitive they need to be as creative and as efficient with resources as they can be. Outsourcing services to another company, at a much reduced rate of cost, is one way to remain competitive. Where services are considered overhead, or the cost of having the critical mass needed is beyond what can be managed, outsourcing becomes a very viable opportunity.

But what are the true costs and considerations in moving towards an outsourced model? Is it really an opportunity? Before you make a decision on going down the "Outsource" path you will want to be familiar with costs that can otherwise easily be 'glossed' over. The following attempts to highlight some of the lower level true costs in order to avoid the financial, not to mention operational, pitfalls ; up front.

CONTEXT

First, some simple context for those who are just entering the domain of outsourcing. Simply put outsourcing is a state where one company contracts with another to deliver a service and/or product on their behalf. In so doing it minimizes the need for a company to build up its own in-house organization which comes along with added overhead related to employees, facilities, infrastructure, administration, and so forth. So, why not have someone else who already has the organization and scale to deliver much more efficiently? Makes sense doesn't it, at least theoretically.

Second, you need to understand that there are multiple forms of outsourcing. There is the managed service in which you truly partner with a company to manage your service or product end-to-end. They take and deliver your services or products without the direct intervention (day to day management) of your company. Your company simply (and I am oversimplifying) oversees what is happening. Then there is the augmentation or OEM model. The company you contract with provides resources to augment what you lack internally for a period of time, or OEM a product for you (they build and deliver, to you, components of a product your company assembles and distributes).

So you think that is it? There's one more layer to be aware of. Outsourcing can be positioned in multiple ways; on-shore (on-site), near-shore, and off-shore; each of which has a different associated cost structure.

- On-shore refers to having resources and services on-site at your company location.
- Near-shore refers to resources and services located close to your organizations proximity, e.g. same time zone or geographical area as your company.
- Off-shore refers to resources and services located (typically) at a location (country) that the contracted company operates from; in a different geographical area and time zone. For example Asia-Pacific is a typical region that many North American organizations are familiar with, but this can include any region of the world (Romania, Costa Rica, Brazil, Mexico, etc).

COSTS

There are a number of factors to consider, and it is no simple matter. Organizations can easily get trapped with the high-level numbers game when reviewing their business case for outsourcing. In so doing they fail to realize the true Total Cost of Ownership (TCO) of the journey they are about to take which includes front-end, transitional, and operational costs; both hard and soft.

What is covered next comes from an IT perspective primarily, although there are universal principles to consider.

Front-end Costs

Front-end costs can easily be under-estimated, starting with how much time will really be needed to find and secure a suitable partner (average 6+ months). Final costs will vary from case to case depending on the scope and complexity of the outsource scenario, see table 1 for key front-end activities.

Table 1: Key front-end activities that inherently have associated costs

Activity / Area	Cost Elements
Requirements collection and assessment	Internal labor costs (# of resources * total capacity allocation [hours] * internal labor rate [hourly rate])
Vendor research	Internal labor costs; potential reference site visits requiring travel
RFP process; initiate, issue, review, interview, shortlist	Internal labor and travel for multiple departments such as Legal, Operations, Purchasing, etc
Fact finding visits for short list	Internal labor and travel
Vendor selection	Internal labor and travel
Negotiations	Internal labor and travel
Formal agreement	Internal labor, potential travel

Front end costs will depend on who is engaged to implement the Outsource Program, their related labor rates, duration of the RFP process, travel required, etc. Some organizations may choose to absorb costs within operational budgets, or other project cost buckets. However, at the end of the day if you are truly going to measure your ROI you need to account for all effort and activity costs, regardless of where they are absorbed.

Careful planning is needed, particularly if an organization does not have its own support functions, such as legal, to support the process. This will result in the need to contract outside help which adds further costs. Travel itself is a high expense item that needs to be carefully assessed as this alone can burn a hole through any budget; a single return air ticket to India from the West coast of N.A. can cost $3-5,000 USD (coach). Multiply this by the number of people engaged, total number of trips, medicals, visa's, lodging, other transportation, food, etc. and you can see that things can add up quickly. For example, using sample June 2009 data for a trip to Bangalore from Vancouver Canada refer to Table 2.

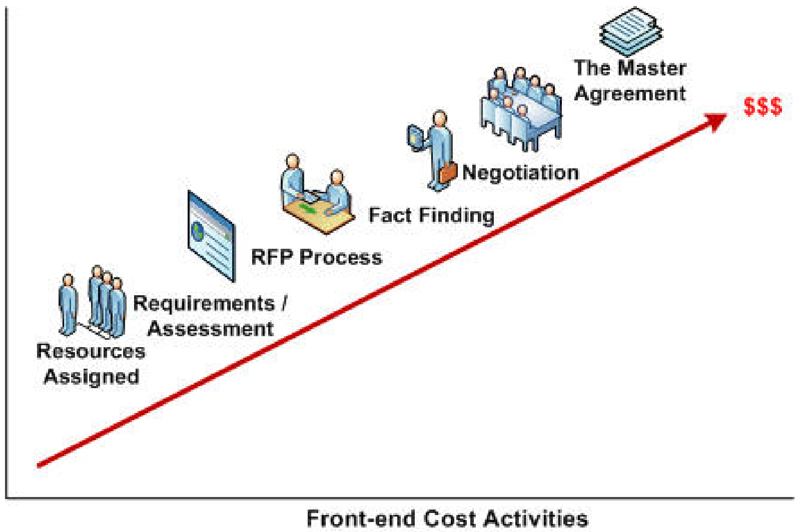
Table 2: Sample Travel Data:

Travel Item	Costs
Return Airfare (Coach)	$2,500 USD * 3 people = $7,500 USD
Hotel	$240/night USD * 7 days * 3 people = $7,500 USD
Food	$650 USD * 3 people = $1,950 USD

Total: $16,950 USD

Final note on front-end costs: depending on the amount of actual costs, and the expected cost savings, it may take 1+ years to recover the upfront investment.

Illustration 1



Transition Costs

Transition costs are also easily underestimated, and yet are a large component of the overall engagement costs. Vendors will outline implementation strategies and methodologies, timelines, resource plans, and more. However, they are based on standard generic approaches that can miss some key elements for your company.

First, depending again on the scope and complexity of an outsourcing initiative it can take 6+ months to transition alone. You can't throw your work over the wall and expect any vendor to pick up and go seamlessly. Ironically, some vendors will advocate that they "know" your business and that they can take your work and not only scale out and meet your needs, but do it independent of the organization that they work for. If ANY vendor advocates that they have the capability to manage and run without any real on-going engagement on your part you should stop them in their tracks. They don't know your business until they are immersed in it over time.

The problem with many (IT) vendors is that they look at things in terms of technology silos, that what they are supporting for you is stable, not subject to much change, and that most things are easily scripted.

The reality is that things change on an on-going basis, processes mature and adjust according to business conditions, turn-over occurs, technology changes, product designs change impacting tooling, quality, and process, etc.

So what does the transition compose of in terms of cost?

Costs will again vary on the scope and complexity of what you are transitioning. However, there are basic hard cost elements to be aware of as outlined in Table 3 below.

Table 3: Basic Transitional Cost Elements (I.T. View)

Transitional Components	Cost Elements
Communications/network bridge setup	Internal labor, hardware, service provider fees, travel
Resource selection (recruitment process) in the event that you want to directly ensure you are getting solid resources	Internal labor
On-boarding and account setup of users; network access, email, applications access, general security access if on-site	Internal labor
Additional licenses. If you are looking to expand capacity, that means more resources overall accessing your systems assuming. You may not already have pre-existing licensing. However, even if this is the case you are assigning work to vendor resources and are therefore absorbing the cost of the licenses as part of the outsource initiative	Application user license costs
Vendor management orientation; overview of commercial agreement and a who's who within each organization at the operational management level	Internal labor, travel
Vendor team/s orientation; 101 of your organization, your business, your department or group, communication styles and expectations, work styles and expectations, processes and procedures, etc	Internal labor, travel
Vendor team/s detailed Knowledge Transfer (KT); detailed training of work to be performed including applicable hands-on and shadowing of your organization’s 'work'.	Internal labor now comprising primarily your organizations higher cost Subject Matter Experts or SMEs, travel

Review of KT phase and readiness to proceed to Stabilization	Internal labor, travel
Vendor team/s stabilization period; your organization shadows the vendor work using the same resources engaged during KT	Internal labor, travel
Review of stabilization Period and readiness to proceed to Steady State	Internal labor, travel

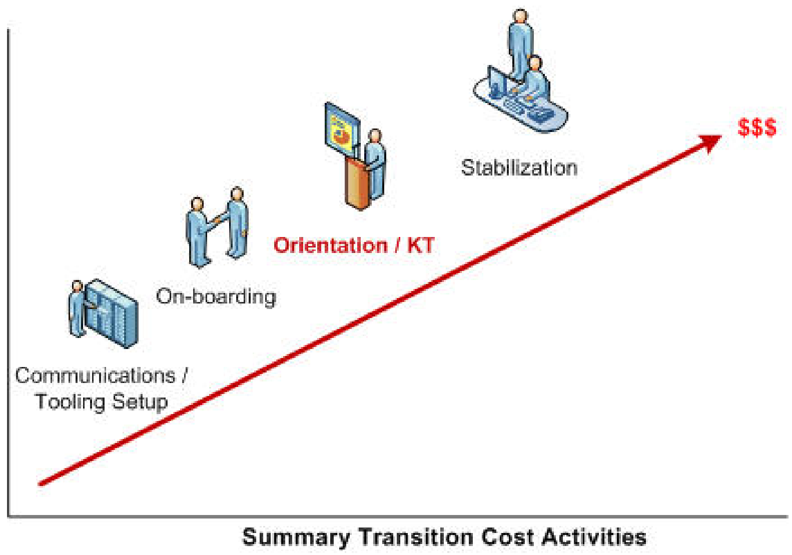
Other additional items that can creep in and increase your costs include:

- Communication costs such as cell phone use overseas
- Training materials and supplies
- Equipment
- Facilities (Rent, Lease, Department Cross Charge of space, etc.)
- Team building activities
- Resource backfill for tasks otherwise covered by resource being assigned to the outsource initiative
- Opportunity Cost

One very important 'soft cost' consideration to make is that of 'Opportunity Costs'. In other words, by assigning your internal resources to focus on an outsource initiative you are effectively saying that all other tasks or opportunities are second priority and can be queued. You are willing to forsake one opportunity, with associated benefits, for another.

This is not something unique and applies to any initiative where you take your skilled resources away from one set of activities and assign them to another. However, it is something that seems to slip by easily. In many cases management assumes that resources can continue to carry out existing tasks and take on new ones without any material impact. The fact of the matter is that each resource has only has so much capacity, or hours in a given day, available. Something is going to give. You will need to give up one opportunity for another unless you have pre-existing free capacity of equal capability.

Illustration 2



Operational Costs

Okay, you have considered Front-end and Transitional costs, the rest should just be a matter of stable on-going costs of service. The vendor is now in a Steady State and your organization should be hands-off with routine daily tasks; related costs of product or services are less than what you could have absorbed within your existing organization.

This is of course is the desired outcome, and in many cases is achieved, but is it achieved to the extent expected. The following cost elements must be considered as part of your on-going Steady State costs in order to truly understand if you are realizing any savings or Return on Investment (ROI).

1. KT is never complete

   It is impossible to take years of experience, education, a person's general capabilities and skills and mirror that in another individual and expect the same level of quality work. It just won't happen, never mind transition to multiple individuals and on-going turn-over.

   Further, even what you are able to provide formal training on, the receiving resource will only absorb 'x' % of what they hear.

   Finally, no amount of documentation will capture all possible scenarios; they capture standard procedures and exceptions, not the nuances of 'analytically' working through a situation that is not 'typical' or 'scripted'.

What does this mean? It means that you need to be prepared for providing additional support for the unknowns or exceptions. This means having a framework in place in which the vendor can easily and quickly tap into your organization for support. This of course means having capacities to provide support or other resources. The time spent providing support, or resources provided, equals cost to you (internal labor or materials).

The level of support will vary depending on the situation, and if the services are based on ‘commodity skills’ and standard processes as opposed to specialized skills, processes, and tools.

Also see Section 3, On-Going Governance

2. Relationship Management

Your organization needs to maintain relationships at both the strategic account level and at the operational level (even more important in this persons mind and yet least attended to). You want to effectively create a 'one team' environment as much as feasibly possible. The benefits are:

- The vendor resource feels part of a team and valued. The more valued and engaged the less likely they are to move on. You have invested a lot of effort and money and want to do what you can do to help control turn-over and the resulting loss of 'Intellectual Assets', not to mention the unit cost of investment for that individual that will now need to be covered again, in one form or another (assuming the vendor has not already built in resource redundancy). This is probably more of a focus with support and development services where the vendor is the SME.

- The more you view and treat the vendor resource as an extended team member, and not just a face-less 'provider', the better the odds with respect to Quality and Timely delivery of service. This results in cost savings related to reduced rework, reduced disruption and opportunity cost to your organization, as well as costs with increased escalations and interventions, etc.

The cost of maintaining a relationship will depend on your organization and the level of engagement they are willing to invest. Typical cost components associated include internal labor (hours * hourly rate, travel * number of resources * number of trips), communications, rewards, etc.

3. On-Going Governance

Governance is an essential component to any outsourcing agreement. At the end of the day your company owns, or needs to own, the service or product that it sells or consumes. This means that you simply cannot have a hands-off approach. It will NOT work! Strong statement perhaps, but it is true. Yet it is amazing how many people think they can.

In fact, if a 'potential' partner ever says to you "we will manage all aspects of the partnership internally, including all on-going knowledge transfer over time, customer relationships, etc”, then run! Why do I say this? Allow me to use the following experience to illustrate:

> We had entered into a commercial agreement. The agreement did not cover specific elements regarding how the partner would operationally perform, or ensure that their services would remain consistent from the point of hand-off moving forward. What they assured us of at a high level, was that they had the means and mechanisms to manage 'all' things once the transition was complete, that it would be seamless and transparent to us. As well, they presented a high level framework that outlined how they would be organized and what their management approach would be.
>
> In short, 12 months after going live with the vendor we had a 100% turn-over of the partner resources in my area focus, and effectively 0% knowledge retention. The impact? Business was no longer being supported (business application support) and key business processes were failing unnecessarily.
>
> Why did this happen? First, we 'bought' into the notion of a hands-off approach. Second, the partner did not reach out to us given they sold us on a hands-off approach and tried to resolve everything on their own.
>
> How did we identify that there was an issue? First, service levels started to deteriorate; calls were not being picked up, little or no responses to recorded issues, issues were not being resolved in a timely manner if at all, key peak period process failures became frequent, and the business was screaming.

The vendor did everything to try and learn and resolve on their own, with no awareness that due to lacking controls over turn-over they had effectively bankrupted their capabilities.

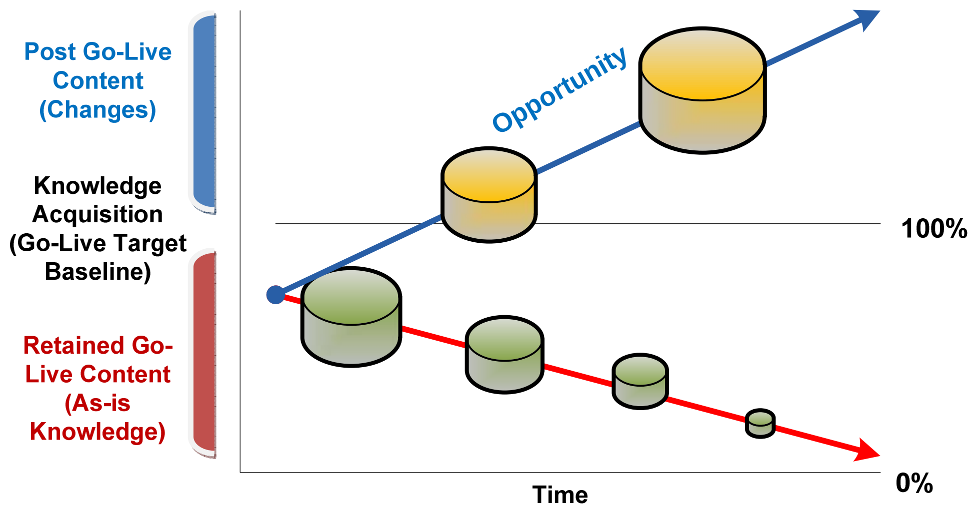
Every organization should 'own' their processes, systems, or products. If this is the case then it is the organization that is the source of deep foundational knowledge, not the vendor you outsource with! Yes you want to build up the knowledge base, but if they know more about your service or product, then you need to ask the question about how secure your organization is in managing growth and change, not to mention being hand cuffed by a vendor. If you are okay with this that is fine, as long as you consider the risks and associated costs.

If you leave it to the vendor to manage all KT they will do what they can, but they only know what they know. Processes and products change, unless the organization is consistently engaged they will never pick up on changes never mind keep pace with as-is knowledge retention.

I refer to the knowledge retention issue as the 'Generational Knowledge Loss Syndrome', the same principle as when you use to copy a cassette tape, each time you copy from one copy to another the quality of the recording gets worse. What happens is this:

1. Resource A conducts KT to resource B; resource B absorbs 80% of what in conveyed
2. Resource A leaves
3. Resource B conducts KT to resource C; resource C absorbs 80% of what in conveyed. Resource C effectively only has 64% of what resource A originally had.
4. Resource B leaves
5. Resource C conducts KT to resource D; resource D absorbs 80% of what in conveyed. Resource D effectively has 51% of what resource A originally had.
6. and so on......

Illustration 3 - 'Generational Knowledge Loss Syndrome'



The cost for this scenario: a repeat of the whole original Transition phase investment (worst case scenario).

Taking the approach of staying engaged and providing on-going refresher KT sessions, updates, housekeeping, and providing rewards and recognitions avoids complete breakdowns. Plan quarterly site visits with the vendor teams as part of a Relationship Management process. The associated costs are internal labor and travel. These costs need to be built into the on-going Operational budgets.

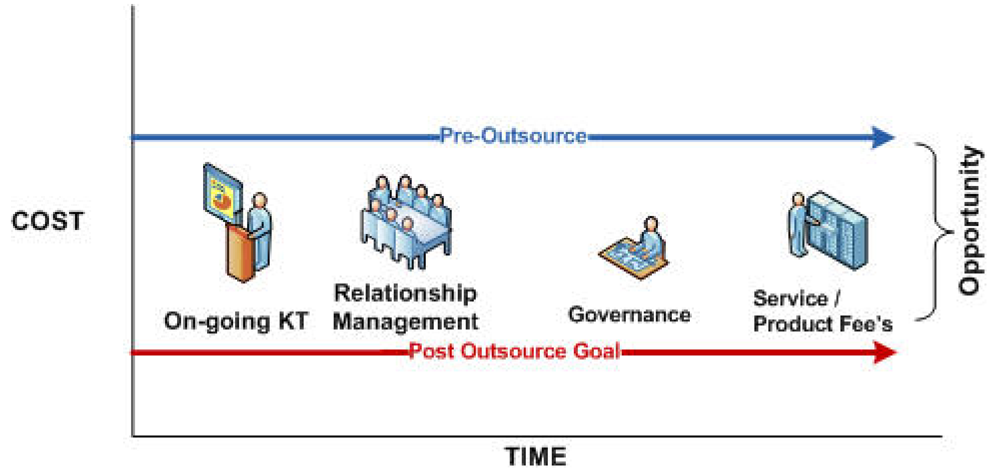
On-going KT sessions may be in the form of conference calls (least effective), video conferences, web based collaboration, face-to-face classroom style (most effective), etc. The associated costs are internal labor, communications, and potential travel. Again, these costs need to be built into the on-going Operations budgets.

Key takeaway; be engaged in understanding the Vendors operational framework and activity. Audit, and collaborate on on-going changes over time.

4. Lastly, and most obvious will be the actual service fees that the organization pays for the services or products delivered by the vendor. This can be in the form of a fixed-fee or time & materials.

Regardless, the objective is to realize cost savings over what your organization could do internally.

Illustration 4 - Operational Cost Summary



SUMMARY

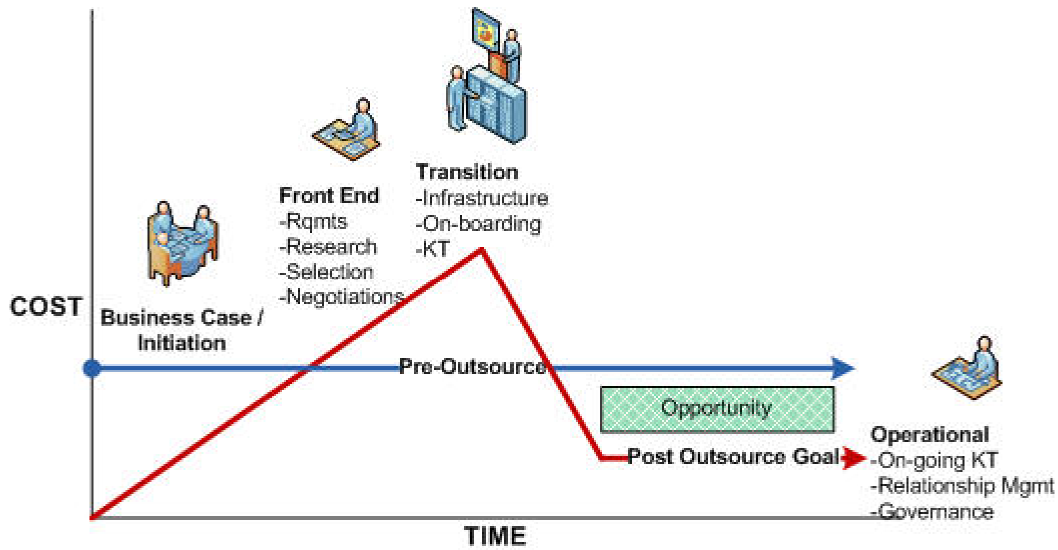
Organizations begin by looking at the high level business case and the ratio of cost vs. opportunity or revenue to outsource one or more business functions. From there they then go through a vendor selection process, build out a Service Level Agreement (SLA) or Master Service Agreement (MSA), and then implement. The agreements address service delivery thresholds, legal conditions, high level statements of work, billing schedule, and so on. This is normally done at an executive level and often fails to sufficiently drill down into the realities of what the 'true' Total Cost of Ownership (TCO) is (front-end, transitional, and operational; both hard and soft). And in some cases, it can prove to be more than what was bargained for, or, what an organization can truly absorb.

As well as costs, quality factors in. You need to maintain oversight over the quality of product and service, monitor, and manage. If the product or service is lacking in quality you will pay for it in the end.

In general, take your time; be sure you have accounted for ALL costs that may be applicable to your organization. Don't fall into the sales trap, be sure to challenge what is offered, and do your homework on the vendors you consider. The following illustration summarizes cost elements to consider when looking at outsourcing. They may not all apply, but they hopefully serve to generate thorough thought in understanding all potential costs and avoid finding yourself on a slippery path towards failure.

For some, outsourcing will simply makes sense with little debate, for others it may be that the costs and risks are simply too great once you consider the details.

Illustration 5 - Cost Element Summary; Objective to Realize Opportunity / Savings

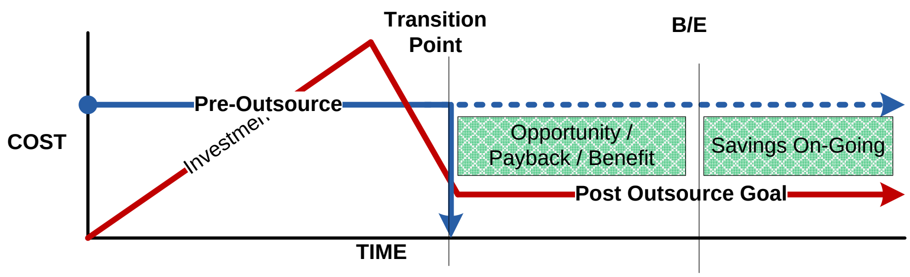


SUPPLEMENTAL

Return On Investment (ROI)

Once you have accounted for all the costs that your organization will need absorb you will want to understand what the actual benefit is, or is not. The way to do that is to calculate the Return on the Investment you are about to make. In other words, will you get your money back and how long will it take. Your organization will have minimum payback thresholds. These thresholds may be based on returns they could make by leaving the money in the bank, or on other organizational investments.

Illustration 6 - Simple ROI Example



As a ratio of financial benefit divided by financial cost

$$\frac{\left(\text{Annual Operating Cost Before Implementation}\right) \text{ minus } \left(\text{Annual Operating Cost After Implementation}\right)}{\text{Implementation Cost (Net new investment)}} \text{ —Example} \blacktriangleright \frac{\left(\text{\$2.2M USD}\right) \text{ minus } \left(\text{\$823K USD}\right)}{\text{\$6.5 M USD}} = 21\%$$

As the period of time within which the cost will be recovered

$$\frac{\text{Implementation Cost (Net new investment)}}{\left(\text{Annual Operating Cost Before Implementation}\right) \text{ minus } \left(\text{Annual Operating Cost After Implementation}\right)} \text{ —Example} \blacktriangleright \frac{\text{\$6.5M USD}}{\left(\text{\$2.2M USD}\right) \text{ minus } \left(\text{\$823K USD}\right)} = \text{5 years to recover costs}$$

Other General Items to Watch For

a. ***When it comes to trying to establish an 'integrated' support model that spans multiple technologies and process areas, you can easily run into road blocks that will take extra time to overcome.*** If you are simply looking for specialists, or support in a certain technology area, generally this is not a problem for most large vendors.

As an example, if you need to support end-to-end processes such as Order-to-Cash which entails EDI transactions that flow into and through internal services, then into an ERP system, and finally out into an external reporting layer, you will be hard pressed. You will more than likely find yourself having to deal with many more resources than expected, each with a particular core competency in a focused given area only. I speak of both Business/Functional skills sets as well as Technical skill sets.

From a cost perspective this may be okay as long as the aggregate costs are equal to or less than the cost to do things in-house yourself now and in the future. Future capacities should scale to accommodate growth without the same rate increase of cost.

b. ***Power redundancy***; does the vendor have redundant power supplies? This is important to look at because if they do not and they go down it will cost you in terms of your organization having to fill the void until such time that the vendor is operational again, not to mention lost revenues. Many regions around the world have sporadic power outages, either planned or unplanned. Some regions are simply unreliable.

c. ***Network stability***; does the vendor and region have stable network services? Are there multiple service providers in the region? If not, it will cost you to work around any disruptions. This can also cost you in terms of lost revenues and ability to keep your business running.

d. ***General social-economic well being of region, political, and security stability?*** Any of these conditions, if unstable, can cause disruption for your outsource provider to deliver on its commitments. Strikes and general unrest will impact your organization. Again, your organization may need to fill the void during unplanned shut downs. Costs are numerous; opportunity costs, internal labor costs, communication costs, and lost revenues to name a few.

e. ***Disaster recovery capability.*** As with power redundancies, network stability, and general regional stability, if there is a disaster, the costs can be extreme. The ability of the vendor to recover and be in operation may be weeks, months, or longer, perhaps not at all. Your organization will need to quickly absorb and fill the void. In this case the overall costs to your organization may be too much. Disaster is a risk no matter where one is located, but the question is how much mitigation is in place to be able to recovery as quickly as possible; are there contingencies?

f. ***Language comprehension and cultural awareness*** can be another element that is glossed over. True, many outsource vendors can cater to various languages; they may even share similar organizational cultures as well as geographical boundaries. However in some cases, where you are in an off-shore model, you can find that there are issues with language comprehension which can result in dissatisfied customers who may turn elsewhere, incorrect interpretation of instructions, general confusion resulting in longer decision making cycles, etc All of these have an associated cost in terms of lost revenue, lost productivity, etc.

g. ***Employee moral*** can adversely be affected when transitioning roles and work outside of the organization. This needs to be carefully managed and monitored. The best laid intentions and communications are not always enough. Human nature kicks in and people begin to worry, loose hope, and in the end become unproductive. Worse, if you are relying on these individuals to provide KT you may find numerous gaps in what actually ends up being transitioned.

   The end result can be multi faceted in terms of cost, lost productivity within the organization, and an un-prepared and ineffective outsource partner that is not operating at expected levels. This can adversely impact revenues and an organization's bottom line, not to mention the intended ROI driving the business case. Costs can also result in lost business or new business, rework costs, increased warranty costs, internal resource costs where individuals are needed beyond what was planned to make up for vendor gaps, etc.

   One way to mitigate these 'worst case' scenarios is to actually engage your employees in the outsource initiative at the outset. Have them participate in the planning, training, development of procedures and processes, make them accountable for on-going success and relationships. Be clear about their futures, do not leave them guessing. For those who may be ultimately let go build in conditional payouts and other support services with their transition (costs should be accounted for as a component of the outsourcing initiative). At the end of the day people value transparency and it avoids built up tension and confusion which can quickly derail plans.

h. Once a transition is complete and the outsource vendor is in full production organizations may consider letting go of internal resources, including those who are most knowledgeable (Subject Matter Experts / SMEs) about the product or service being transitioned. Careful consideration must be made; where applicable, efforts should be made to retain ***(key) SMEs*** either thru transitioning into other areas, or, position them in a role to support the on-going relationship with the vendor.

   Why? Consider this, by not doing so you have effectively handed over control to the vendor. The vendor has not necessarily absorbed everything during the Transition phase; see Section 3 - On-Going Governance, illustration 3. Unexpected situations can occur that the vendor may not be prepared to handle requiring additional expertise. In these cases you are again risking additional costs with potentially having to contract expertise to help out, absorb additional costs related to inefficiencies, realize lost revenues, etc.

What if the vendor is simply unable to live up to its obligations, or, is about to go out of business? Consider Satyam in 2008, an India based outsourcing company. The company almost came to its knees due to accounting fraud. The outlook for the company was grim, employees were looking elsewhere for work, salaries were at risk, moral was at its lowest, and many organizations needed to look at alternatives quickly given the grim outlook at the time.

Without having any remaining expertise within your organization how do you transition to yet another company, or, pull the work back into your own organization? The cost can be huge in terms of your organization ability to function, or deliver goods and services.

Each organization needs to assess what risks they are willing to accept and absorb, and each will need to determine how much they are able and willing spend in order to retain in-house expertise. If the expertise can be retained in one way or another then the labor cost is absorbed as part of general on-going operations. If not, then the labor cost should be accounted for as part of on-going outsourcing support costs.

h. ***Cost structures will change over time.*** Regions that have typically been inexpensive to outsource to will, and are, becoming more expensive. With social-economic improvements as a main contributor costs will rise. At what point will you see a break-even scenario, tough to say, the key is that each organization needs to be vigilant to proactively understand the makeup of their costs and associated decisions that may be needed to adjust their existing outsource model. If a vendor change is a consideration due to high service costs, be prepared to repeat the whole cycle and absorb the associated costs once again.