Business-IT Strategies Advisory Service
Executive Update Vol. 12, No. 11

Update

The Outsourcing Business Case:

A Focus on the Financials

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Before you invest heavily in an outsourcing initiative, you must make sure there is a compelling rationale based on sound economic analysis. An outsourcing business case is the basis on which each "go/no-go" decision will be made.

A general approach to business cases covers an assessment of the following:

- Expected benefits, both tangible and intangible
- Identified risks (major things that could go wrong)
- Expected financial payback (the quantitative benefits less the total cost of contract)

This *Executive Update* focuses on the financials — calculating the total cost of contract (TCC) and the payback — to get the total economic picture, which is much more than just the provider's price. But first, you must understand that, to be of any real value, a business case has to be an ongoing analysis, and not simply an exercise you complete, put on the shelf, and forget.

If you are considering outsourcing, then your evolving business case must address at least three go/no-go decisions:

1. Your initial business case is based on best estimates, so your first go/no-go decision determines whether a competitive process is a go.
2. Your next phase of the business case is based on the bids received, so your second go/no-go decision determines whether negotiation is a go.
3. Your final business case is based on the results of these negotiations, so your last go/no-go decision determines whether the deal is a go.

The initial business case determines only whether market testing is a go. Many of the numbers in your initial business case are only estimates. You won't have the actual bids yet, so you won't know what providers actually charge. You won't have the mobilization plan from the bidders, so the costs of transition are also speculative, and so on. Ideally, you will have done some sensible market investigations to determine what constitutes a reasonable estimate. This includes asking potential providers, talking to existing customers, or conducting some online pricing research.

Once you receive the bids, you have all the "real numbers." Then you can update your business case after you have chosen the winner as part of the evaluation reporting process — the go/no go to enter into negotiations, or what has to be achieved in the negotiation to make the contract a go.

Following the negotiations, when the final numbers, deliverables, conditions, and so forth, all have been agreed to, you can update the business case to help you determine whether you should sign the contract.

When preparing numbers for your business case, you must begin by deciding on one basic principle — whether the numbers you use will be optimistic (i.e., the results you hope for) or pessimistic (i.e., a more conservative estimate).

Without an explicit decision here, it is almost certain that your organization will eventually suffer from either intentional misrepresentations in business cases, or from the well-known corporate disease of *optimism bias*; that is, the demonstrated systematic tendency for people to be overly optimistic about the outcome of planned actions, including overestimating the extent and likelihood of positive events and underestimating negative events.[1] Such bias must be accounted for explicitly in appraisals, if they are to be realistic. Optimism bias typically results in cost overruns, time delays, and benefit shortfalls.

A good way to find out the extent of optimism bias in your organization is to examine previous business cases

and the extent to which their goals were actually achieved. Check the degree to which assumptions were proven to be valid, that costs were accurately estimated, that expected risks were correctly foreseen and mitigated, and that expected benefits were realized. Once you know this, you can factor in your organization's optimism bias into your business cases. Or even better, learn where your organization has proven to be defective in formulating its business cases, so you can avoid repeating the errors of the past.

In complex deals, you may want to prepare two estimates in order to represent the best and worst cases. If the business case holds up under the worst case, it is a very strong case. If it does not, your organization will be taking on more risk than may be prudent; the expected benefits are less likely to be achieved, and the costs will probably be understated.

We now move to the financials, beginning with determining the total cost of contract.

TOTAL COST OF CONTRACT

Business cases involving outsourcing typically have the TCC as the key method of determining the cost of each solution. The TCC is used repeatedly throughout the outsourcing lifecycle; specifically, in the following:

- Estimating each TCC for the various solutions in the initial version of your business case
- Calculating the TCC for each bid in order to choose the best value for money
- Updating the initial version of your business case with the winner's TCC (second business case)
- Updating the second version of your business case with the final negotiated TCC (final business case)
- Tracking the actual TCC over the life of the agreement
- Estimating each TCC for the various solutions for the next generation (the end-of-contract options)

The TCC is made up of five key calculations:

1. Provider's charges
2. Cost of your organization's contract management over the life of the deal, from mobilization through to disengagement
3. Retained costs that you cannot eliminate immediately, such as leases or corporate overheads
4. Mobilization costs, representing the costs of getting the deal in place, excluding contract management
5. Exit costs, representing the costs of unwinding the deal, excluding contract management

Each of these are discussed in turn, using Table 1 as an example. The table shows figures for a three-year office equipment and support contract. The TCC estimate for this contract over three years, including mobilization and disengagement, is about $4 million.

1. Expected Charges

In the initial version of your business case, the "provider charges" are the amounts you expect to be charged. As discussed earlier, the initial business case has the best estimate of what providers charge. Then, when you update the business case after a tendering process, these become the charges as per the winning bid. During the life of the agreement, these become the actual charges.

Note that the example has separate columns for the two "bookend" transactions in an outsourcing deal, mobilization and disengagement. Unless the provider is going to write off its mobilization and disengagement costs as part of the cost of sales (which is rare), its costs are buried in the fees. So, for transparency, it is better to have the provider disclose it in the bid and for you to show it separately in the business case.

In our case, the winning bid charged a mobilization fee, had ongoing charges that the client estimated would increase at least by the Consumer Price Index each year, and had disengagement charges at the end of the contract representing all the activities required under the contract to hand over operations to a successor.

2. Contract Management

These are the activities required to manage the deal, including strategic and tactical governance, measuring and evaluating performance, reporting, and resolving

Table 1 — Example Total Cost of Contract (in Thousands)

		Normal contract operations				
	Mobilization	Year 1	Year 2	Year 3	Disengagement	**Total**
Provider charges	250	825	852	881	125	**2,933**
Organizational costs						
Contract management	40	160	160	160	80	**600**
Retained costs		387	164	-		**551**
Mobilization costs	78					**78**
Disengagement costs					24	**24**
	118	547	324	160	104	**1,253**
Total cost of contract	**368**	**1,372**	**1,176**	**1,041**	**229**	**$4,186**

All figures are tax-inclusive

issues. For this, include the cost of each full-time equivalent (FTE) from any centralized function (e.g., legal, sourcing, finance), the business units involved with the provider, and anyone else to be involved in contract after signing.

In our case, the client estimated one FTE for contract management during the mobilization period and then four FTEs for ongoing management, with two FTEs managing disengagement obligations of the incumbent provider.

3. Retained Costs

Not all preexisting costs can be immediately stopped or transferred to a provider. There could be sunk costs that you will continue to incur, at least for a certain period. Examples include:

- Equipment leases that are not transferable due to the provider's solution or restrictive lease provisions
- Redundant assets, net of disposal proceeds
- Supply contracts with a minimum guaranteed volume that cannot be renegotiated (these must expire before they can be realigned to the new volume requirements)
- Office and facility leases that will now be vacant space, requiring time to be sublet or renegotiated
- Retained staff that the provider will not be requiring, will not be made redundant, and are not part of the contract management strategy — until they are redeployed
- Corporate functions (e.g., HR, IT) that will need time to reduce the resource base to what is required

In our case, the retained costs involved equipment leases the client could not get out of without paying the lease in full. The client decided to retain the equipment as per the original lease and have it replaced by the new provider when each lease expired. All leases expired within two years.

4. Mobilization Costs

Mobilization, or startup, costs represent the expenses necessary to put your organization's deal into operation. Such costs include your organization's FTE cost involved in managing the mobilization and verifying that all key aspects of the mobilization have been completed. They may include special mobilization costs, such as those involved in exiting previous contracts redundancies.

In our case, the client's costs included staff redundancy payouts (for previous support personnel) and FTEs of various business unit personnel required to move equipment around, as well as the IT support required to integrate the new equipment into the client's network.

5. Disengagement Costs

There are always costs to get out of a contract, even one that has reached a natural end (via expiry, as opposed to early termination). You may want to consider a provision for disengagement costs, depending on what probability you give to keeping the provider for the next-generation deal. There will be costs to your organization in unwinding the provider, including verification of delivered data and records potential assignment/novation of licenses, and invoking intellectual property rights, to name a few.

In our case, the client's market research showed significant reductions in the price/performance ratio each year, suggesting that switching providers would be likely at the contract's end. The research estimated the FTEs of

Table 2 — Example Payback Calculations With a Baseline (in Thousands)

		Normal contract operations					
	Mobilization	Year 1	Year 2	Year 3	Disengagement	**Total**	
Baseline		1,870	1,930	2,069		**5,869**	
Less: Total cost of contract	368	1,872	1,176	1,041	229	**4,186**	
Payback	-368	**498**	**754**	**1,028**	-229	**1,683**	**29%**

All figures are tax-inclusive

various business unit personnel required to remove the incumbent's equipment and the IT support required to remove the equipment from the client's network.

PAYBACK

The payback represents the remaining financial result after taking into account the TCC. For example:

- If the sourcing initiative is to result in savings (e.g., buying technology to cut labor costs), the payback equals projected savings less the TCC.
- If the sourcing initiative is to result in increased revenue (e.g., buying technology to increase sales), the payback equals projected revenue increase less the TCC.
- If the sourcing initiative is to replace something in existence (e.g., replacing obsolete technology with new technology, replacing a current supplier with a new one, or outsourcing work currently performed inhouse), then the payback equals baseline[2] costs less the TCC.

Our case involves the last situation, replacement of existing equipment and outsourcing support. Table 2 illustrates the resulting payback calculations of our example. This shows that despite the additional mobilization and disengagement costs, there are still significant savings to be made.

Of course, once you have this number, it is easy to calculate a payback period, the time required for the return on an investment to repay the sum of the original investment, but that is a subject for another day.

ENDNOTES

[1]Lovallo, Dan, and Daniel Kahneman. "Delusions of Success: How Optimism Undermines Executives' Decisions." *Harvard Business Review*, July 2003, pp. 56-63.

[2]A baseline is the current status quo, adjusted for any planned changes.

ABOUT THE AUTHOR

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Dr. Cullen is a widely published author. Her publications include *The Contract Scorecard*, *Intelligent IT Outsourcing*, *Outsourcing: Exploding the Myths*, *Contract Management Better Practice Guide*, *Best Practices in ITO*, *Lessons Learnt in Outsourcing*, *Service Provider Management*, *Outsourcing Guidelines*, and *Outsourcing: What Auditors Need to Know*, in addition to research with various universities since 1994, including the London School of Economics, University of Melbourne, Oxford University, and the University of Warwick. She has been featured in such publications as *Australian Financial Review*, *Business Review Weekly*, *Computerworld*, *Directions in Government*, *European Journal of Information Systems*, *Information Economics Journal*, *Journal of Strategic Information Systems*, *Information Technology Report*, *Insurance Directions*, *Oxford Handbook*, *MIS*, and *MISQ Executive*. Her expertise is globally recognized, and she performs peer reviews of outsourcing research for *Harvard Business Review*, *California Management Review*, and *European Conference on Information Systems*. Dr. Cullen has lectured at many universities, including the University of Seoul, the University of Melbourne, the University of Monash, the University of Swinburne, Queensland University of Technology, and the Royal Melbourne University of Technology. Dr. Cullen earned a BS in accounting from St. Cloud State University (US); she was awarded a master's of management (technology) from Melbourne Business School, and earned her PhD from the University of Melbourne. She is also a Chartered Accountant in the US. She can be reached at scullen@cutter.com.