



**SAP White Paper**

# **THE IMPACT OF TECHNOLOGY ON COST IN BUSINESS PROCESS OUTSOURCING**

**The Complete Business Process Outsourcing Cost Picture**

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## **EXECUTIVE SUMMARY**

Many different factors contribute to the cost of a business process outsourcing (BPO) engagement. Among them, IT, especially software, is a key cost determinant that is often underestimated. While software licenses and maintenance typically represent no more than 3% to 5% of a BPO provider's total cost, they directly drive process automation that immediately impacts the cost of operations.

Technology drives the BPO cost structure in three ways: it enables economies of scale, supports sustainable process optimization, and makes labor arbitrage possible by connecting and controlling remote location workflows.

With the right software, organizations can balance their needs for personalization and standardization of outsourced processes by creating the capacity to design process and IT implementation jointly. In addition, software is the key enabler for integration between buyer and service provider, both on process and IT levels. Finally, the software choice has a substantial long-term impact on cost as it influences the organization's flexibility to accommodate changes in scope including process coverage and regional scope, or scale; allow for organizational developments, such as reorganization or merger and acquisition activities; and cater for potential changes in sourcing strategy.

This white paper is the first in a series of SAP white papers, which examines the cost structure associated with BPO and shows that a diligent assessment needs to address several cost components that are not included in the provider's total contract value (TCV), and are often overlooked by buyers. Subsequent white papers will look at how technology impacts all BPO cost components in detail and compare the cost of different BPO delivery methods based on comprehensive modeling.

## TECHNOLOGY IN BUSINESS PROCESS OUTSOURCING – WHY YOU SHOULD CARE

What is the impact of technology on the cost of a business process outsourcing (BPO) relationship, and why should BPO buyers care about technology in the context of BPO?

Until not long ago, the buyers' community was often uninterested in the technology portion of BPO because it was viewed as a consideration the provider is paid to figure out. Not paying attention to this detail typically would manifest significant conflicts later when the buyer would end up paying more for the outsourced processes than anticipated or not receive the expected service quality. For those buyers who cared, BPO vendors would simply point to the high cost of software licenses and enterprise resource planning (ERP) software.

Since BPO buyers invest significant time, money, and other resources in the BPO project, it helps both buyers and providers to understand the BPO cost structure, and the impact of technology on it, as clearly as possible. Here are some guidelines to understanding the BPO cost structure.

- Software licenses typically represent 3% of the cost of a complete BPO process in regard to HR outsourcing.
- Other technology costs relate to about 15% of BPO process costs with the majority spent on consulting services and internal resources for implementations and upgrades. Another sizable chunk is the cost of the hardware and connectivity.
- Manpower and related administrative costs such as equipment, utilities, and buildings make up about 80% of the BPO cost total. This cost is very sensitive to economies of scale. For example, if the size of the organization triples, the cost of payroll as well as time and attendance per employee will decrease by approximately 30%.

Figure 1 illustrates that in order to reduce costs through technology, minimizing the software license expenditure alone is not sufficient. The implementation- and upgrade-related costs, plus hardware and operations costs, should also be considered, as well as the impact of standardization and automation on labor costs that benefit from economies of scale.

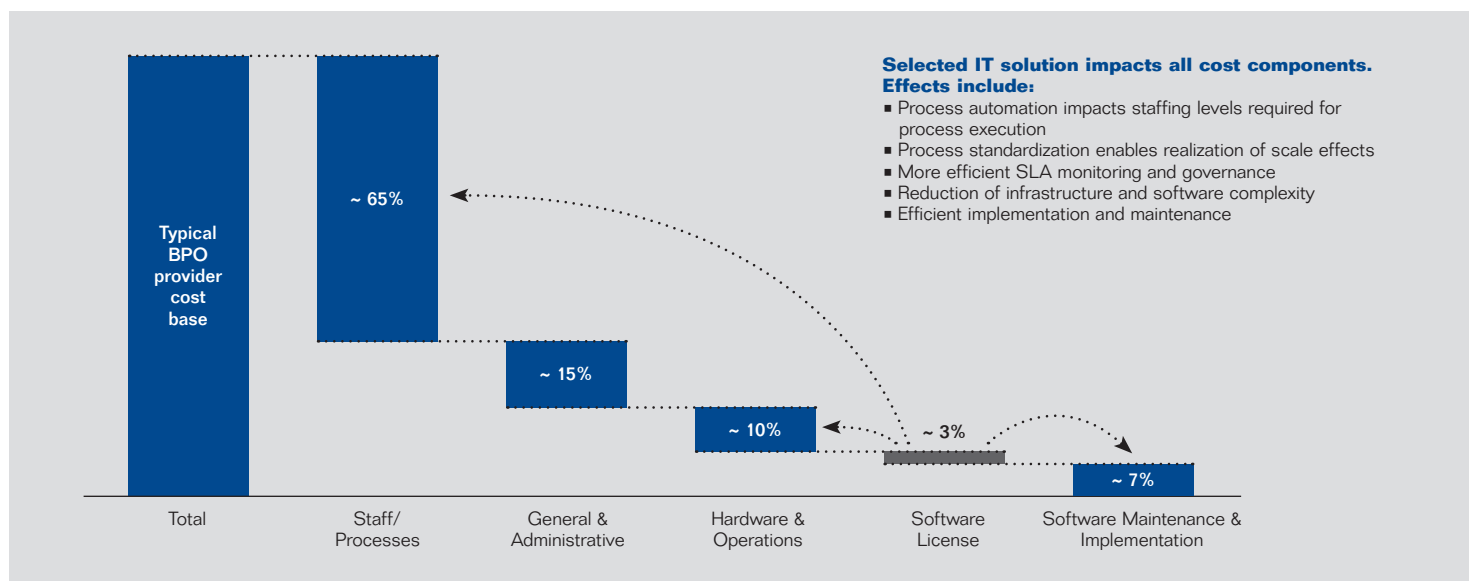


Figure 1: Breakdown of a Typical BPO Provider's Cost Structure

Especially when it comes to software implementation, today's BPO customers can learn from the experiences of some earlier ERP implementations that were not successful and lead to spiraling IT costs and unsatisfied users. By following established implementation best practices, or at least setting and respecting some ground rules, technology-related risks (especially financial ones) can be minimized. At the same time, typical danger points lie in the crude, one-to-one translation of preexisting business rules into software code and the buildup of related interfaces without taking stock of the trade-offs between customization and cost.

With modern, well-designed software, these pitfalls can be navigated. Based on built-in functionality such as configuration switches or predetermined blueprints called configuration sets, it is possible today to accommodate a range of personalization while substantially lowering the cost of implementation and upgrades. Implementations that bypass this functionality and resort to custom code may be initially easier and faster for inexperienced solution architects or programmers but can be more expensive (and sometimes unpredictably so) in the future. Likewise, relying solely on business considerations and neglecting the IT impact can lead to situations where best-of-breed or proprietary solutions are considered. This often results in creating additional interfaces whose cost in the short term (initial build out) and long term (rebuild when adjacent systems change) can be substantial. These scenarios are highly common especially in large technology implementations where stakeholders in specific countries or business units have the power to force blueprint fragmentation.

### **Managing Costs Through Technology**

Through optimizing the part of the customer's IT that is included in the scope of the BPO agreement and related capital expenditures, the BPO provider can often reduce the complexity of the IT landscape and thereby cut costs – **if** it is given the mandate and **if** it has deep knowledge of the technology platform. Authority and competency are key topics that merit discussion between both buyers and providers during the BPO sales cycle with the help, if appropriate, of an outsourcing advisor.

However, even when the BPO provider is able to compress and manage the technology cost structure of BPO, other even taller orders may lurk ahead. Most importantly, to sustain savings over time, the BPO provider must address labor costs since they represent the largest expense. Technology savings are typically not enough to justify a multiyear outsourcing agreement's business plan so the BPO provider must standardize processes and automate them. This will help reap the economies of scale that generate savings, enable investment to keep the processes efficient in the future, and stay ahead of the future savings requirements.

Another significant focus of concern is when adjacent technology and processes are not properly improved, or at least adjusted, to accommodate BPO. Even if the cutoff point between retained and outsourced processes is clear and well defined, interdependencies exist. Even worse, the retained processes must now accommodate what the outsourced processes require. In the case of HR processes, for example, conventional wisdom maintains that core HR components, such as payroll and master data, can be decoupled seamlessly from the rest of the HR applications. However, for those HR organizations that want to become strategic, they should use components such as a skills inventory and leverage

organizational data that spans across the enterprise and bridge the (artificial) process boundary between the BPO customer and provider to obtain better resource allocation and a global view of company performance.

Both the impact of technology on the sustainability of savings and the necessary alignment of outsourced and retained processes and technology have profound implications for the BPO industry. BPO providers must be able to articulate the value of standardized processes to the buyers, so they can make decisions based on the entire cost structure – not just on the BPO contract value. In addition, the cost for the rest of the buyer organization should also be taken into account. The Hackett Group<sup>1</sup> reports that the most effective companies manage to cut HR administrative costs by up to 25%. These companies typically have ERP-based, standardized processes.

In addition to these challenges, BPO customers need to consider the cost of a potential exit scenario. While most BPO partnerships are entered in good faith, strategy changes, merger and acquisition activities, or a changing project scope, may precipitate a provider change or even re-insourcing. The respective additional cost can easily mount up to the same cost level as the initial migration project, or even exceed it. With the right technology, process configurations, and end-user settings, all underlying data can get transferred much more easily and quickly, and the exit achieved at dramatically lower costs.

### **Cost Control: Shared Responsibility of BPO Customer and Provider**

Instinctively, the option to just pass on responsibility for the cost structure to the BPO provider and work out any conflicts based on the BPO governance structure is tempting for a BPO buyer. However, overall cost structures are not easy to control and can exceed the planned levels. Also, part of the process cost is generated by the retained organization and not controlled by the BPO contract. BPO customers should thus consider and factor into their budget some wiggle room for nonfixed costs such as time and materials expenses, governance costs, one-off projects, and other incidentals that may add substantial costs.

Even if costs do not get explicitly transferred to the client, they generate a strain on the BPO provider that ultimately puts pressure on the quality of delivery. Service level agreements (SLAs) cannot typically cover all areas (countries, business units, processes) where quality performance may decrease. Ultimately, BPO providers operating under duress might ask to renegotiate the contract elements such as price and SLAs.

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1) From “2005 Performance Metrics and Practices of World-Class Human Resources Organizations,” December 2005

## BPO COST STRUCTURE: THE COMPLETE PICTURE

Cost reduction is still the main driver behind most BPO decisions. Closely examining the cost structure of a BPO engagement first will help better assess the achievable cost savings and understand how technology drives that savings. Initially, the easiest and most obvious approach would be to look at the total contract value (TCV) of the BPO services as agreed with the BPO provider. However, TCV is hardly a comprehensive indicator of the overall cost.

Figure 2 illustrates some of the main cost components that contribute to the true full cost of BPO and need to be considered by BPO customers in their business case building and decision making as well.

BPO costs manifest themselves in several different ways. While some costs are expected and consistently occur, others are less obvious and some can even surprise a customer and cause them

to incur significantly higher than expected costs. The following section provides a closer look at these cost aspects, grouping them into three categories: the usual costs, the surprising costs, and the sneaky costs.

### The Usual Costs – Costs Normally Considered by BPO Customers

This group includes the most obvious and easily identified costs. These are usually addressed within the scope of the TCV or acknowledged by BPO customers during their decision-making process. Typical cost components in this group include process transition, process operation, IT, and governance costs. While these cost items are well known and understood, dealing with them still requires care and well-planned process and IT design.

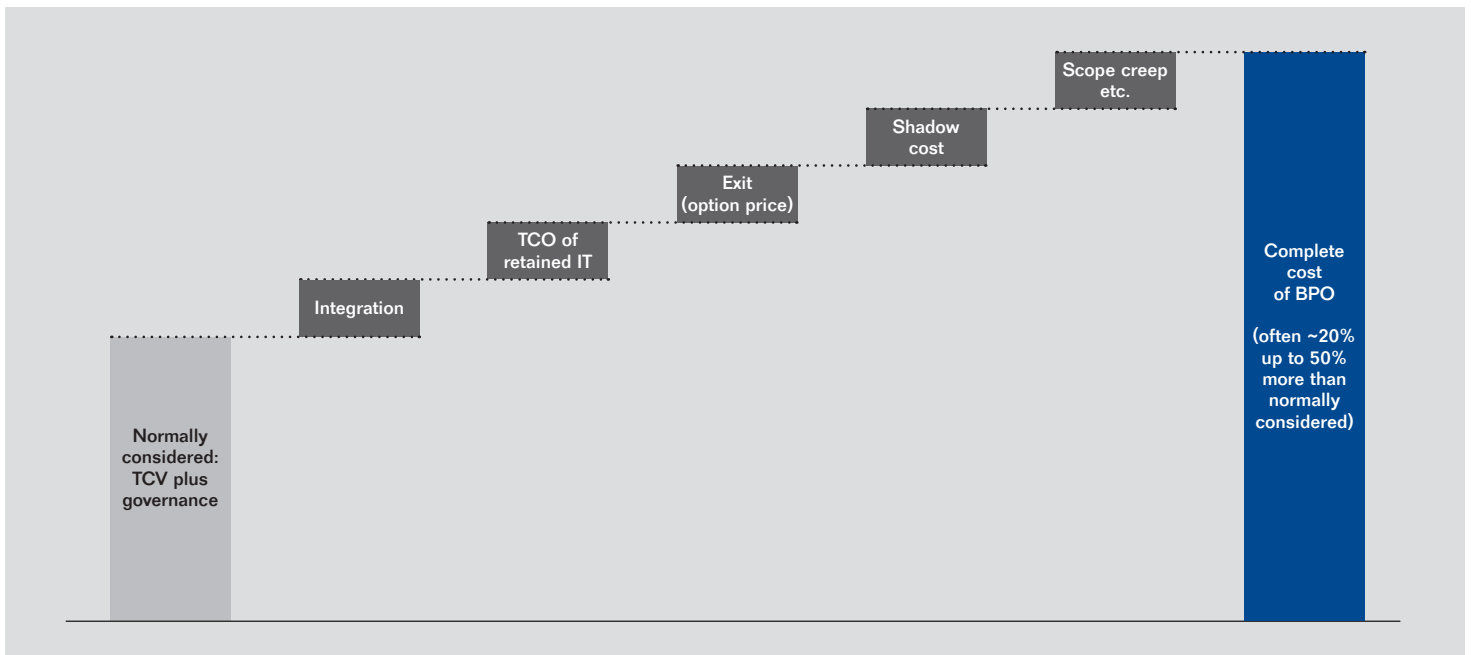


Figure 2: Additional Cost Elements Contributing to the Full Cost of BPO (illustrative)

### **Transition of People, Processes, and IT Systems**

A cost-efficient transition toward a steady state of operations can account for a substantial portion (up to 20%) of the BPO deployment. Related costs occur both for the BPO provider, who will normally charge them back as a part of its overall pricing, and the BPO customer who incurs charges for external support such as that provided by specialized BPO advisors and process consultants.

Cost items typically considered include the following:

- **Process implementation** – This includes process mapping and IT blueprinting and required solution development (custom code) or personalization (in case of an ERP implementation).
- **Migration of process and staff** – Costs include physical relocation of assets, such as furniture, computers, and files, as well as those staff brought on board by the BPO provider. Other related costs include severance to all other affected staff, training both process-operations staff and end users, an often staged solution rollout to the locations and/or parts of the organization in scope, and providing first-level support for the duration of the transition.
- **Migration of IT** – Costs include up-front software fees, hardware and infrastructure outlay (where necessary), physical or technical migration, data migration, and solution deployment.
- **Governance** – Costs include expenses related to any organization established to manage both the transition project and more permanent, ongoing relationship both on the BPO customer's and provider's side.

### **Process Operations**

Once operations have been transferred to the BPO provider, the company takes over complete execution and managerial responsibilities of the respective processes. Since BPO today is mostly applied to labor-intensive, back-office processes such as finance and accounting, HR, and procurement, the largest cost block to the provider is clearly personnel related. Cost items typically considered include the following:

- Labor to run the outsourced processes; many BPO contracts today contain a clause that provides for a reduction of this cost item over the duration of the contract
- Expense to monitor business performance, as well as quality and efficiency of the employee interaction
- Cost for associated general and administration overhead

Including respective general and administrative charges, process operations account for up to 80% of the provider's total cost base (see Figure 1). Accordingly, these costs are mainly driven by the provider's cost of labor and the staffing levels needed to run the processes. Providers operating mainly onshore will see proportionately higher labor costs than those who use offshore resources. This situation is becoming increasingly relevant to nearshore operators as well. As a result, it is becoming more important to automate processes that reduce staffing levels.

For the BPO provider, one main optimization approach is to leverage economies of scale by aggregating operations since smaller locations usually operate on comparably higher cost per transaction. If processes from a number of these smaller locations can be consolidated into one location, and at least a part of the process is both centralized and standardized, then the greater the value of that leveraging.

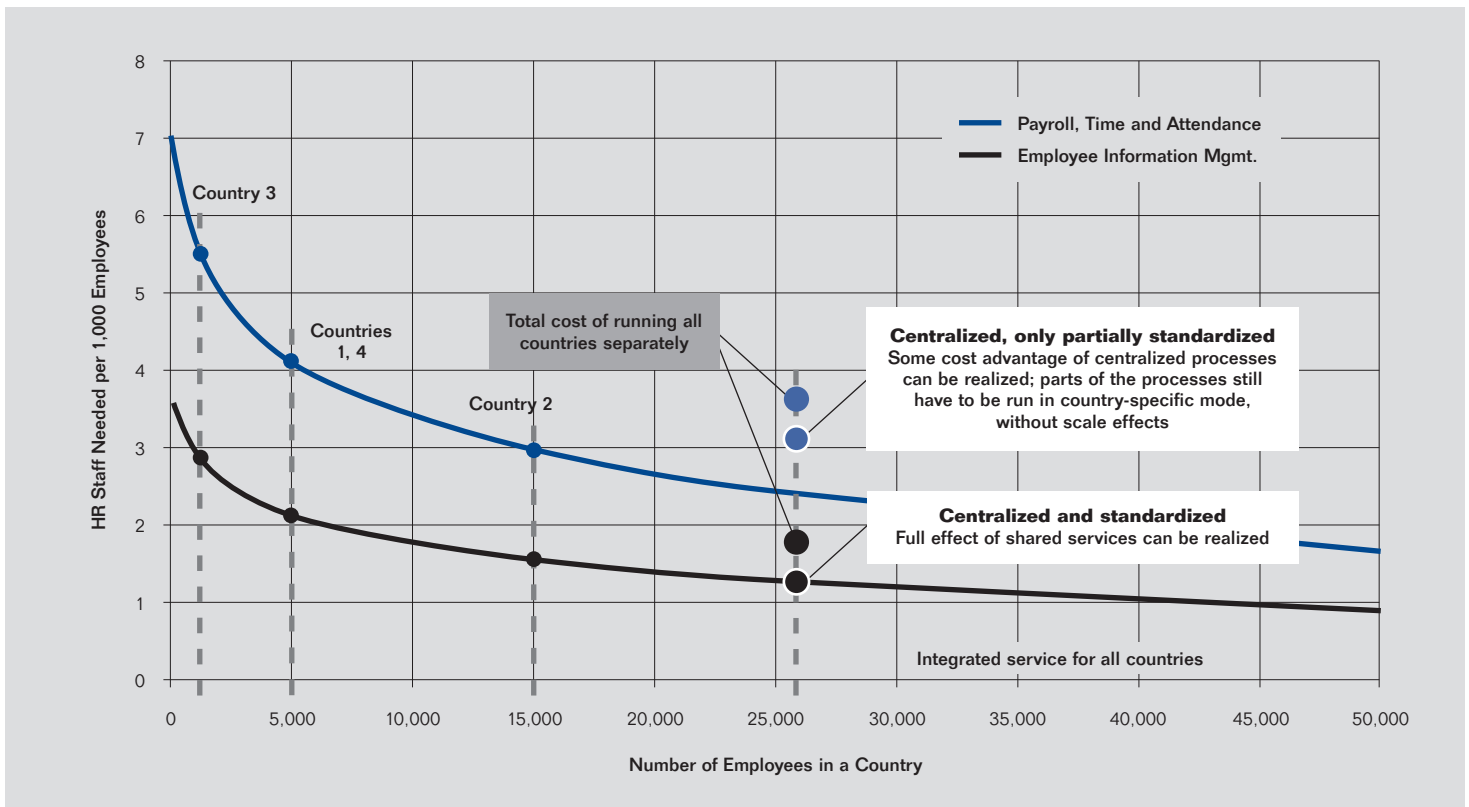


Figure 3: Economies of Scale for selected HR processes<sup>2</sup>

Figure 3 illustrates these scale effects for two typical BPO processes and indicates how centralization of operations will enable a significant reduction in staff required, especially if the processes are also standardized. It should be noted, however, that complete standardization may often be impossible due to local regulations such as those imposed on payroll by country-specific legal, tax, and social security regulations.

### Information Technology

In many BPO deals, a large part of the IT needed to provide the outsourced processes is handled by the BPO provider. Since the BPO provider can potentially leverage significant economies of scale, its cost base is often much better than that of the BPO customer. In fact, customers also frequently say an expected benefit of BPO is the fact that providers have better access to and benefit more from investments in new technology.

2) Source: SAP Analysis of data from ASUG, The Hackett Group, confidential case example (Global 500/5bn manufacturing company)

IT costs typically comprise software license or usage fees, maintenance and upgrade expenses, labor costs relating to application management, maintenance and upgrades, integration with the BPO customer's systems, the operation of data center and physical equipment (hardware, infrastructure), and all business-critical system performance monitoring. Overall, IT typically represents a share of 15% to 20% of the BPO provider's cost base.

Implementing ERP is not a banal exercise, and IT costs have been observed to constitute up to 40% of the provider's cost base in cases where an ERP implementation went wrong. By establishing and enforcing some ground rules ahead of time, technology-related financial risks are absolutely manageable. One dangerous practice to be avoided is the crude and direct translation of preexisting business rules into solution requirements, resulting in the buildup of numerous interfaces and unmanageable custom code. To have a successful BPO engagement, it is essential to ensure that trade-offs between customization and long-term cost impacts are well understood up front and factored into the overall BPO decision making.

**Outsourcing Governance**

Both on the BPO customer's and provider's side, a group needs to be established that manages the ongoing relationship between the two parties. Also, the agreed performance measures have to be tracked, reported, analyzed, and, where necessary, acted upon.

While the BPO provider's governance cost will typically be priced into the overall TCV, a customer's governance cost, which will be in the range of 3% to 5% of TCV over the life of the contract, must be accounted for separately.

**The Surprise Costs – Less Obvious, Easily Overlooked**

While costs in this group are not secret and should theoretically be included during a diligent BPO evaluation, they tend to be less visible than the "usual costs" and often overlooked. These cost items include integration expenditures and the capital outlay of potential exit scenarios.

**Integration Costs**

Most BPO providers will offer both initial IT integration and ongoing interface maintenance activities as part of their service package. The respective costs will be priced into overall TCV and become part of the customer's business case and decision making.

At first glance, integration costs appear fully covered, but what about the costs incurred by the BPO customer itself? After all, both the customer and provider need to maintain their respective sides of any interface, and most changes to one end of an interface implicate some rework at the other end as well. Maintaining an interface can be an elaborate affair and the task gets more difficult as the number of interfaces increases. SAP research suggests that annual maintenance of an average interface in a high-complexity environment is three times more expensive than in a low-complexity environment (see Figure 4).

| Integration Complexity        | Low   | Moderate | High   |
|-------------------------------|-------|----------|--------|
| Number of interfaces designed | 20    | 30       | 45     |
| Total labor hours             | 7,340 | 14,790   | 46,440 |
| Total labor per interface     | 367   | 493      | 1,032  |

Figure 4: Interface Implementation Effort as a Function of Integration Complexity in HR<sup>3</sup>

3) SAP white paper mySAP™ Human Resources: *Tight Integration With Multiple Solutions*, 2003

The sheer number of interfaces can quickly add up and become mind-boggling. For example, the mySAP™ ERP Human Capital Management solution alone has more than 100 implemented and predefined integration points, including intrahuman capital management interfaces as well as interfaces for cross-HR applications, other ERP functions, and external systems. If half of these interfaces, for example, have to be manually implemented and maintained, an extra cost item of approximately 9% of TCV can be the result. For more details, please refer to the subsequent parts of this SAP white paper series.<sup>4</sup>

#### **Impact of Potential Exit Scenarios**

All BPO contracts are initiated with the intent of establishing a long-lasting partnership between the customer and provider. With the sophistication of both sides growing, most partnerships today are initially designed with long-term perspectives in mind. Nonetheless, circumstances can change and a contract might not get renewed even if the partnership is healthy. For example:

- BPO customer may want to bring outsourced processes back in-house for strategic reasons
- Scale or scope of the outsourcing arrangement changes over time and moves out of the provider's sweet spot, for example if the BPO arrangement is expanded to countries not covered by the provider
- Partnership could be impacted by a merger or acquisition on either the provider or customer side, as showcased in the Bank of America/First Boston merger, which led to a shift of BPO activities from Exult to Fidelity

In any such exit scenario, significant costs will arise, regardless of whether the customer decides to discontinue outsourcing the processes or move them to another provider. Several factors contribute to this situation:

- **Loss of process know-how** – During the outsourcing process, the BPO customer can lose most of its process-specific knowledge. Consequently, the customer or the new BPO provider will have to build up the respective skills and potentially re-hire new staff. With just minor assistance most likely from the former provider, serious costs will be incurred – potentially even more than the initial transition. According to the SAP BPO cost model, these costs can add another 10% to the overall cost of the BPO engagement.
- **Redesigned processes** – Outsourced processes are redesigned and will be well documented during the transition phase of a BPO project. However, processes change over time, especially as the BPO provider applies optimization efforts on top of the natural evolution most business processes undergo. The documentation of such changes, however, often does not meet the standards set initially. Hence a significant portion (if not all) of the process blueprinting and design might have to be repeated.
- **Technology transition** – Transitioning the BPO implementation from the former BPO provider's IT systems to the new environment will have to be managed, which can open up a customer to potentially even more work and cost than in the original transition. This can all be exacerbated if some of the functionality has been deployed through custom code implementation. Complexity also increases significantly when processes and the respective data have to be transferred from one provider to another, as now three constituencies (rather than two in the initial setup) are involved.
- **New RFP process** – Potentially a complete request-for-proposal cycle has to be executed, which involves selecting and negotiating with a new provider.

While many BPO contracts will get extended, BPO customers are well advised to include the **potential** cost of such an exit early in their BPO assessment and to consider risk-mitigation strategies.

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4) Available in Fall 2006

### **The Sneaky Costs – Overlooked Costs with Potentially Significant Impact**

This group includes cost factors that are difficult to see or predict, but if noticed too late, can easily erode the expected value of the BPO engagement. These “sneaky costs” tend to have a ripple effect if the outsourcing affects the retained organization’s other processes. When determining the ultimate cost of the BPO engagement deployment, BPO customers should also budget in anticipated costs from scope creep or gliding cost paths, which is when certain cost positions change over time according to actual requirements.

### **Effects on the Retained Organization**

Many of the processes that are the traditional focus of outsourcing engagements have limited interdependencies with processes in the rest of the organization, which is actually one reason why they are prime outsourcing targets in the first place. BPO customers usually assume, if only implicitly, that the decision to outsource such processes has minimal, if any, impact on the retained organization. A typical example is payroll, which can easily be decoupled from other business processes, including the rest of HR to some extent. The integration points can be handled relatively well through interfaces between the respective IT systems.

However, even payroll is not completely without interdependencies that may impact the cost base of the retained organization. For more integrated business processes, outsourcing will have an even greater impact on the quality and speed of retained interdependent processes. Consider management of overtime (depicted in Figure 5), which is part of the frequently outsourced HR function of time and attendance management, as another specific example.

This process has numerous integration points with the retained organization, including other HR processes (compliance with legal constraints and union agreements), finance and accounting processes (accounts payable for subcontractor payments), and operational processes (production planning).

### **Cost of Errors**

Every error made during an outsourced process has implications not only for the BPO provider, who needs to redo the task, but also for the retained organization. Usually, the detection, assessment, and reporting is handled by an employee during his or her normal working hours. Especially for occasional users, the individual impact of errors will be small; however, overall it becomes substantial. Consequently, if the number of errors can be reduced through the technology on which BPO is based, both the provider and the retained organization can benefit significantly.

### **Ripple Effects**

Commercial BPO providers have a natural incentive to optimize their operations over time, and as part of many BPO deals, are explicitly required to do so. A provider will make constant changes to the outsourced processes and do so independently from the customer’s setup. However, any change in the outsourced processes will have an impact on interdependent processes – and thus potentially on the BPO customer’s cost base. For example, changes to the previously mentioned overtime management process will affect diverse retained processes, such as the ones provided above.

### **Employee Satisfaction**

In a perfect setup, the outsourcing of processes will go unnoticed by the retained organization. Unfortunately, this is often not the case. People are often resistant to change and sometimes the perception of change in processes and the people executing them can drive down employee satisfaction even if there has been a seamless transition. This is especially true throughout the transition phase when errors are bound to occur more frequently. Those errors can also receive higher visibility in areas such as payroll. The exact magnitude of these costs, such as lost organizational efficiency due to employee dissatisfaction, is difficult to quantify. However, well executed BPO can tangibly help increase employee satisfaction.

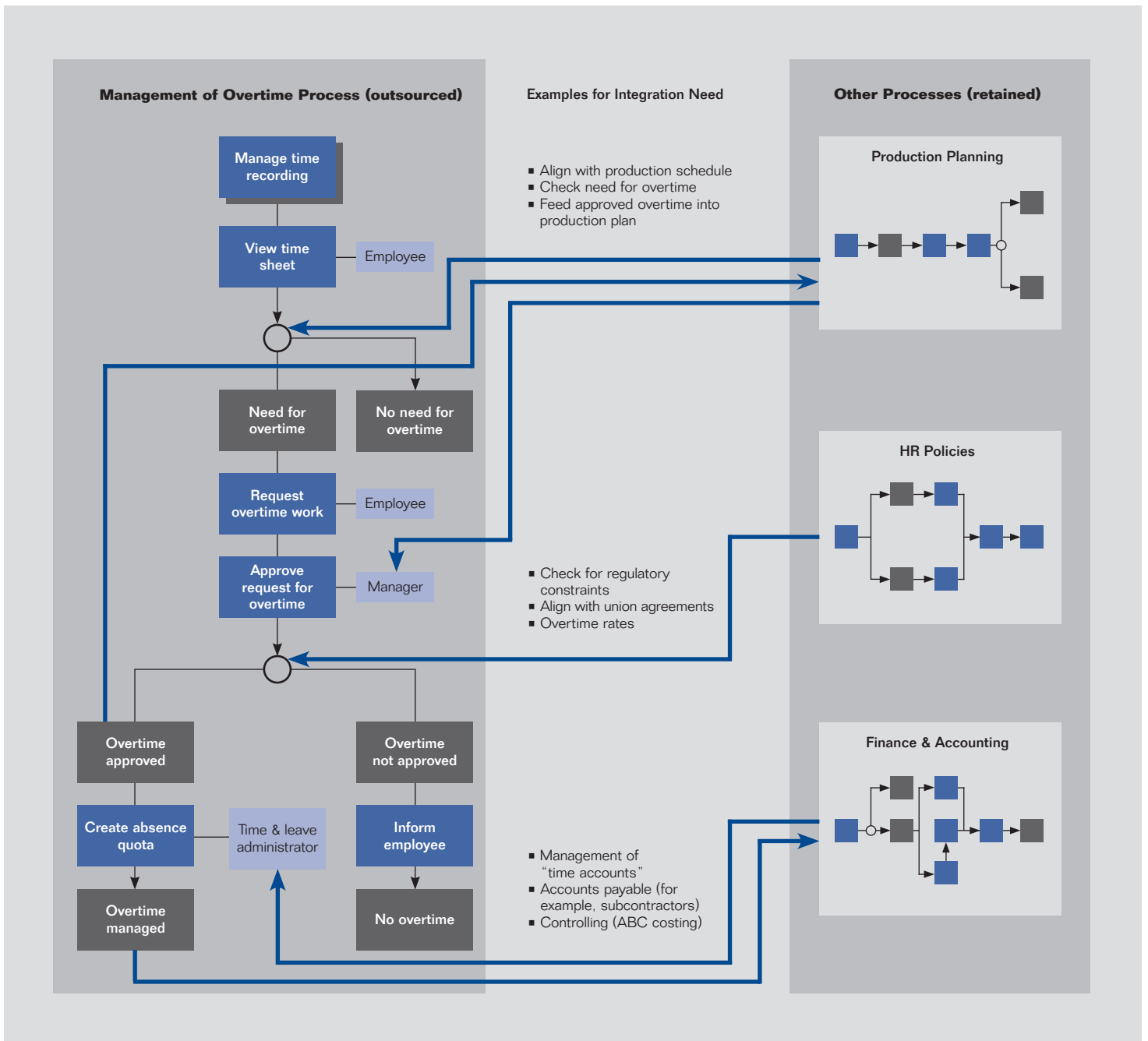


Figure 5: Potential Interfaces of Management of Overtime into the Retained Organization<sup>5</sup>

5) Source: SAP Business Consulting HR Process Repository

### **Scope Creep and Gliding Cost Paths**

It is a common misperception that once a BPO contract is signed, costs are set in stone. Instead, several dangers loom that might drive the price of the BPO services up over time. For one, not all the outsourced costs are fixed: time and materials expenses, governance costs, one-off projects, and other incidental expenses may add substantial costs. Also, not all savings are guaranteed. Negotiated gliding cost paths may be difficult to achieve if the BPO relationship is not functioning well. Finally, you need to recognize and understand the financial dangers of when cost and complexity start creeping back into the BPO engagement over time in the form of additional interfaces, handoffs, and general “shadow costs” as mentioned previously. This is especially true in BPO engagements where initial process design was mostly left at its pre-BPO stage because of reasons such as reduction of blueprinting cost or having to overcome customer-internal resistance to BPO.

## **CONCLUSION AND OUTLOOK**

As previously discussed, companies considering BPO as a strategic option should carefully consider the complete cost picture before embarking on the journey. As part of the BPO evaluation, several cost components need to be considered that are often forgotten but can have a significant impact on the overall profitability of the endeavor. Such items include integration costs, costs of a potential exit, several possible types of shadow costs, and costs that occur during the lifetime due to scope creep and/or gliding cost paths.

Technology has a deciding role in reducing and controlling these BPO costs, and any respective choices made by the BPO provider have an impact far beyond the parameters of the agreed TCV. In fact, BPO customers should closely monitor all technology-related decisions, as they directly impact their own cost base. In addition to these cost aspects, the impact of technology choices on the quality of, and risk associated with, the BPO engagement must also be taken into consideration.

The subsequent parts of this SAP white paper series will address the following aspects:

- How technology impacts all BPO cost components in detail
- How the costs of different BPO delivery models compare
- How technology impacts the quality of both the services delivered by the BPO provider and of retained processes
- How technology can help mitigate the risks associated with BPO

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