The Real Costs of Business Process Outsourcing

A Coracall Whitepaper
Introduction

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.

Technology in BPO – Why it’s important

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 recently, 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. 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%.
Typical BPO provider cost base

- IT Solutions – 65%
  - Process automation impacts staffing levels required for process execution
  - Process standardization enables realization of scale effects
  - More efficient SLA monitoring and governance
  - Reduction of infrastructure and software complexity
  - Efficient implementation and maintenance
- Staff/ Processes - 15%
- General & Administrative - 10%
- Hardware & Operations - 3%
- Software Licenses - 7%

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 Group¹ reports that the most effective companies manage to cut HR administrative costs by up to 25%. These companies typically have ERP-based, standardized processes.

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 non-fixed 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.

Transition of People, Processes and 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.

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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

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.

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.

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.

Hidden Costs

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.
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.
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