

Creating Superior Outsourcing Relationships

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Activity-based Outsourcing

Activity-based planning and analysis results in increased productivity, better contracts and long term relationships.

The Primary Matters Guide®

The Primary Matters Guide® is Primary Matters' activity-based application used to produce the analysis contained in this paper. Please visit our website to view our [Narrated Presentations](#) which will provide a detailed understanding of the value activity-based analysis and The Guide™ can add to your outsourcing relationships.

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Outsourcing is a strategic business decision. It can provide a cost effective means to allow an organization to focus on core competency, but it requires significant management effort, careful analysis and clear measurement to ensure that objectives are successfully met. Outsourcing needs to be evaluated with an eye to the strategic impact it should provide. An outsourcer specializes in their competency, keeping up with “best practices” and learning from work with a range of organizations.

As outsourced corporate functions grow in importance, the management relationship with the outsourcer needs to evolve to foster the healthy long-term relationships required for success. In particular, it requires focus on defining the value and goals of the relationship and on providing transparent measurement of the outsourcer's performance against these goals. It is important to identify what critical resource is to be staffed by employees versus outsourcers. ***When will an outsourced function enhance the strategic value of an organization?*** Outsourcing should be an opportunity to:

- Improve marginal product cost and customer life time value.
- Continually implement productivity and quality of service improvements, via technology or workflow re-engineering.
- Gain geographical and cultural knowledge in order to interact with the customer in a quality manner.

Many organizations can't appreciate the effort required to ensure an outsourcing relationship will deliver to expectation. A successful relationship requires well-documented processes, clear objectives, development of a continuous communication channel and willingness to adapt to achieve measurable results. Some key points of importance to ensure a solid relationship:

- Goals of the company are clear and the outsourcing relationship is aligned to those goals.
- Actual work accomplished can be measured and validated.
- Processes and procedures are clearly defined and agreed upon.
- Forecasts on volumes of work and resources required to accomplish this work are projected accurately.
- Clear metrics and analytics are used to ensure monthly invoicing is accurate.

- Joint innovation and process re-engineering are supported to continuously improve performance.

It is surprising how few organizations understand and address these issues, and instead manage their outsourcer's performance based on monthly retainers, fixed headcount or specific metrics (volume forecasts, service levels, or abandonment rates). Productivity improvement, customer satisfaction, revenue generation and automation are rarely included in the contract.

There is a growing recognition that the generic forms of relationships with outsourcers, embodied in today's contracts, are not meeting the desired business goals. An emerging method for increasing the quality and productivity of outsourcing relationships is based on the use of activity-based planning and analysis solutions.

Activity-based Planning and Analysis

Activity-based analysis provides a structure for:

1. Projecting work volume based on organizational strategic goals that relate to demand-based forecasts for resources. This provides a strong foundation for achieving desired results. Examples of strategic goals include product sales targets, marketing campaign projections, or projected growth in accounts.
2. Clearly defining activities and work processes so actual work performed can be monitored and measured. These may be sales calls, closing new customers, turning on new services, providing product support, or supporting customer inquiries.
3. Marrying the work volume forecast with the resources required to complete the work effectively whether that is human, technology, facilities or other resources.
4. Applying resource capacity and productivity algorithms to the volume forecast and the work processes to produce budgets, resource requirements and activity-based costs.
5. Enabling wide-ranging business impact analysis – the ability to create and compare 'what if' scenarios that quantify the impact of changing any of the goals, work processes, or resources. Total Cost of Ownership and Return on Investment is clearly identified in each scenario.

Transparency Provides the Foundation for Evolving Relationships with Outsourcers

The attributes of an activity-based planning and analysis solution create **transparency** into the way the outsourcer performs work. Transparency is about identifying and quantifying how the work is being done, what resources it takes to do the work, how much it costs and how these measures change over the planning horizon. As a result, instead of managing an outsourcer's performance using the most common measures – number of cases opened and closed, number of calls or emails handled - transparency enables the capturing of exactly what work is being performed, the cost of each activity performed to accomplish this work, and the cost and benefit of making changes.

For example, the following table provides a view of **how and at what cost** two different outsourcers process applications arriving from prospective customers. The two outsourcers have chosen totally different approaches. The first outsourcer is using less experienced and less costly labor for the first several steps in the process – entering and checking data as well as correcting errors. The second outsourcer is applying more experienced, more expensive resources for doing the same tasks. However, the result is that the more experienced personnel take significantly less time and have a lower error rate.

**Establishing Best Practices Using Activity-based Analysis
- Processing New Customer Applications -**

	For each New Application, how many times is this Task Done?	What Resource is used to do it?	Fully Weighted Cost per Hour	How Long Does it take to do this Task?	What does it Cost?
Outsourcer 1 Tasks:					
Data Entry	1 Time	Clerk	\$22.00	15.00	\$5.00
Evaluation	1 1/2 Times	Clerk	\$22.00	12.00	\$6.60
Correcting Errors with Applicant	50% of Applications	Administrator	\$28.00	20.00	\$4.67
Approval Process	1.2 Times	Loan Officer	\$45.00	15.00	<u>\$13.50</u>
TOTAL					\$30.27
Outsourcer 2 Tasks:					
Data Entry and Evaluation	1 Time	Loan Analyst	\$28.00	10.00	\$4.67
Correcting Errors with Applicant	10% of Applications	Loan Analyst	\$28.00	8.00	\$0.37
Approval Process	1 Time	Loan Officer	\$45.00	15.00	<u>\$16.88</u>
TOTAL					\$21.92

On the surface, one might think that the offer from the first outsourcer is better, since their labor rates are lower. However, activity-based analysis shows that the second outsourcer is significantly less expensive with a cost per application that is 28% lower than that of the first outsourcer, and will also lead to a better quality of customer service since there are many fewer errors to be addressed in working with the applicant.

Under a labor-based contract, one would notice that the first outsourcer is processing fewer applications, but would not know why. It would also be difficult to learn from the

more successful outsourcer, complicating the process of achieving standardized best practices when an organization uses multiple outsourcers to perform the same work.

The 'transaction-based' view of their work would potentially lead to a termination of the first outsourcer, when simply working with them to improve processes may have solved the problem and prevented the very costly task of finding a new outsourcer to do the work. An activity-based view of the work reveals the underlying reasons behind the transaction and labor-based cost differences, thus providing the transparency to learn from and improve the performance of the suppliers.

Activity-based Analysis Improves Relationships with Outsourcers

The insights provided by transparency illuminate the opportunities to change an organization's approach to outsourcing and to reap productivity gains. In particular, transparency provides the ability to:

- **Embody Higher-level Business Goals into the Contract with the Outsourcer.** This leads to significantly better long term relationships and productivity gains by ensuring that the outsourcer is aligned with the organization's goals.
- **Jointly Pursue Best Practices and Total Quality Management.** Since there is an understanding of the underlying cost drivers, whether they come from the way the outsourcer does the work, or the way the company provides support, there is the ability to address and reduce the sources of unnecessary cost.
- **Better Monitor Performance of the Outsourcer.** Management information, focusing on the most important data for understanding the work, managing the outsourcer, and driving improvement is available.
- **Make Informed Decisions.** Scenario analysis enables experimentation in both business process re-engineering as well as evaluation of technology investment. This reduces the risks associated with the outlay of significant effort and capital expenditure to achieve productivity and quality increases.
- **Plan for Future Changes.** Use the results of scenario analyses to plan future change initiatives. Monthly tracking is available to ensure the desired changes are realized, and both client and outsourcer remain aligned.
- **Develop Metrics and Scorecards.** Metrics are developed that relate directly to the work being performed. This in turn ties directly to the resources required to perform the work, which is tied to monthly invoices, metrics, and scorecards.

Information Outsourcers Need to Provide Better Bids

The price of outsourcing is highly dependent on the type of work required, the volume of the work and the ability of the organization to forecast volume accurately. Outsourcers can become frustrated with prospects and customers because forecasts are often inaccurate and the work is often vaguely defined. This results in staffing problems...either too many people or too few. Outsourcing is not a high margin business. Overstaffing can create major financial problems. Significant departures from a forecast that leads to significant losses force the outsourcer to take remedial actions to cut expenses. Understaffing can cause quality of service to decline. As the outsourcer reacts by rapidly hiring the required staff, they may be penalized by the contract.

In order to ensure a relationship that is profitable for the outsourcer and efficient for the customer, outsourcers need:

- Clear, forward looking estimates of the volume of work they are to support.
- A good understanding of the details of the work they are to do, and the time it is likely to take them to accomplish the work.
- A good understanding of the business goals, so that they can create an appropriate framework for structuring the relationship.
- A method of accommodating change, so that if demand is not what is anticipated, the outsourcer does not bear major financial losses.

The power of activity-based planning and budgeting solutions is revealed under these circumstances. Since there is a transparent view of the forecast and the work that is done to meet this demand, it is easier and faster to create strategies for dealing with the variance. After all, forecast variance is a fact of life. First, with transparency, there will be 'early warnings' so that there is more time to adjust resources. Second, with the understanding of how work is done, it can be re-engineered quickly when needed to best handle the changing conditions. Third, it is easier to account for forecast variance in the contract, so that the parties have a better understanding of what to do and how the relationship will handle such variance.

All of these factors lead to an improved ability to handle the natural changes in business and, thus, lead to a better relationship.

The Primary Matters Guide® is used as a key tool in the development of reliable forecasts supporting RFPs and contract negotiations with outsourcers. Using The Guide™, an organization gathers all of the key data, activities, and resource requirements to develop a solid forecast.

All of the information required by outsourcers in the bidding process is available in this activity-based planning and budgeting solution. The reports from The Guide™ lead to the most economical bid for both the customer and the outsourcer.

The Guide™ supports "what-if" scenario analysis, enabling the parties to understand how they will proceed if demand forecasts vary, or if they wish to pursue initiatives changing productivity or customer relationships.

The Guide™ allows joint goals to be defined and measured enabling performance-based contracts to be established.

Total Quality Management with Activity-based Analysis

Total Quality Management (TQM) is founded on understanding and evaluating business processes. It can lead to significant improvement in quality, and consequently productivity increases. Activity-based analysis can drive TQM by highlighting the drivers of work and the associated costs.

Many companies use more than one outsourcer to support a business function. Some companies also have their own operation supporting the same work. This multiple

sourcing, driven by concerns over managing cost and providing business continuity can provide a wealth of productivity opportunities.

By implementing an activity-based analysis solution, a company can learn which business processes are the best from a quality and cost perspective. An innovation implemented at one place can be spread to the other outsourcers performing the same function, thus leveraging the value across multiple suppliers. The potential cost savings can be reliably projected, providing the elusive 'so what' that is needed to initiate change.

Major productivity gains can result by transferring these business processes among organizations.

Activity-based Planning and Analysis Benefits Customers AND Outsourcers

Contracts between customers and their outsourcers are structured in a number of ways. Two of the most common are:

- **Labor-based Contracts** where there is an hourly or monthly rate. The contract anticipates a general volume of work, has quality of service goals, and places constraints on the total hours used in accomplishing the work. Outsourcers might agree to implement productivity measures, but there is a burden on the customer to provide sufficient volume to keep resources fully occupied and to ensure a consistent revenue stream for the outsourcer.
- **Transaction-based Contracts** where the outsourcer is paid for completed transactions. The definition of a transaction varies based on the work. Typically there are goals for quality of service, as well as an expected transaction volume. On the surface, this type of contract could encourage the outsourcer to find ways to be more efficient so that the same number of resources can process more transactions. This, however, requires sophisticated systems that track metrics such as first-call resolution.

In both cases, forecasting is a key component of the service and the outsourcer's penalties are tied not only to their performance, but also hinge on the ability of the customer to accurately project work volume.

With the advent of activity-based planning and analysis, a new form of contractual relationship between customers and their outsourcers is emerging. This new contract type is called a Goal-based Contract.

- **Goal-based Contracts** where the customer and their outsourcers establish efficiency and quality goals that foster continuous improvement. This is accomplished through transparency into the work being performed, the resources required, and volume projections based on demand forecasts. The customer and their outsourcers can then jointly investigate efficiency and effectiveness initiatives, quantify the potential impact, and share in the benefits of achieving the goal of the initiative.

The table below summarizes the many benefits of deploying an activity-based planning solution, regardless of the contract type.

The Benefits of Activity-based Planning and Analysis

	Benefits for Transaction-based and Labor-based Contracts	Additional Benefits of Goals-based Contracts
Basis of Contract	<ul style="list-style-type: none"> • Transparency into the actual work being performed, whether paid for by unit of work or by unit of time. 	<ul style="list-style-type: none"> • Ability to specify in the contract that the rewards for improved performance will be shared.
Definition of Business Goals	<ul style="list-style-type: none"> • Business Goals are made explicit and are easy to communicate. • The resources required to achieve the business goals are identified and quantified. • Customer and outsourcer goals become aligned. 	<ul style="list-style-type: none"> • Incentives can be created and managed that encourage the outsourcer to exceed the Business Goals. • Customers can rely on outsourcers to proactively point out issues or opportunities.
Supporting the Bidding Process	<ul style="list-style-type: none"> • Outsourcers have detailed information on the work to be performed. • The work to be performed is linked to the resources required to perform it. There are no surprises regarding the staffing requirements. • Risks to both the Outsourcer and the Customer are reduced. 	<ul style="list-style-type: none"> • Scenarios can be run as part of the bidding process that identify the impact of different staffing strategies. • Bids can be awarded based on future improvement, with clearly stated ROIs.
Measuring Performance	<ul style="list-style-type: none"> • Performance is measured based on work performed. • Each month, forecasts are replaced with actuals. • Each month, trends are reviewed to see if projections need to be adjusted – in time to adjust with quality. 	<ul style="list-style-type: none"> • Long-range performance targets can be set and monthly tracking is easy to accomplish. • Both the customer and the outsourcer are clear about and agree upon the source of the performance improvement.
Total Quality Management	<ul style="list-style-type: none"> • Best practices that result in the lowest cost are identified. • Best practices can be shared with other sources, leveraging the benefit. 	<ul style="list-style-type: none"> • There is a clear incentive to develop best practices. • There is a clear incentive on the part of the outsourcer to continuously improve.

(TQM Continued)	<ul style="list-style-type: none"> Standardization of processes reduces training and other personnel related costs. 	
Increasing Productivity	<ul style="list-style-type: none"> Productivity improvement initiatives can be analyzed to understand the benefit in advance. Priorities can be established based on potential cost savings. Results are believable because assumptions are clear. Multiple initiatives can be analyzed. Time can be re-directed to up-selling and proactive customer contact. 	<ul style="list-style-type: none"> Productivity improvement becomes a shared goal that is easy to define, measure, track and reward.
Forecast Variance and Changing Business Conditions	<ul style="list-style-type: none"> Trends are reviewed monthly. Forecasts are adjusted and staffing implications are immediately understood. Changing business conditions can be looked at through the lens of 'what if' scenario analyses. Enterprise alignment with the outsourcer on the impact of variances is achievable. 	<ul style="list-style-type: none"> Outsourcers are encouraged to look for trends and find opportunity. Long-term relationships form between the customer and the outsourcer, increasing profitability for both.

Conclusion

It may take several contract iterations to move to a goal-based contract. The path to that end reaps rewards regardless of where it starts. The rewards include a much-improved relationship between customer and outsourcer. This improved relationship is based on a common understanding of the work to be outsourced, and the resources required to perform that work. An improved relationship results in improved profitability for both parties. Achieving a Goal-based Contract will ensure both parties have an incentive to seek out continuous productivity and efficiency gains. This, also, will result in improved profitability for both parties.

Regardless of contract type, activity-based planning and analysis provides the transparency and contract manageability that fosters longer and more compatible outsourcing relationships.