

Quantifying Outsourcing Intangible Benefits

This paper presents the basis for quantifying the intangible benefits of outsourcing initiatives in economic terms.

Abstract

This white paper provides outsourcing buyers and providers with an overview of a process to assess and quantify outsourcing intangible benefits. The paper explains how, when assessing the economic impact of a benefit, the classification of the benefit as tangible or intangible is not as important as understanding the predictability of its measurable effect and the degree to which it causes that effect. Key to the evaluation of this uncertainty is the application of knowledge and reference data to generate a scenario analysis, in which results are applied to the proper variable to derive an expected range of results (from worst case to best case).

About the Methodology

The principles described in this white paper are a few of the elements of the Economic Value Creation™ (EVC™) methodology from Glomark-Governan (www.glomark.com). The complete EVC methodology is contained in software tools—the Glomark-Governan Genius System™—which include models and processes to assess the Total Benefit of Ownership™ (TBO™), the Total Cost of Ownership (TCO) and the Total Risk of Ownership™ (TRO™) of investments in technology (such as IT) and service initiatives (such as Outsourcing).

Introduction

“The management of a company has two proposals before it. The first suggests that the company invest in a new energy-savings outsourcing solution that will immediately and directly reduce utility costs. The second suggests that more people are doing more on-line purchasing for the type of products that they sell, and suggests spending to outsource their Web portal to capture a larger portion of this rapidly growing market. Each outsourcing proposal shows the same return on investment; the same economic impact on the corporation. Which should the management select?”

This case dramatizes the difference between the “tangible” and the “intangible” benefits of investments in outsourcing. A strict financial viewpoint would recognize no tangible difference between the two alternatives. However, any reasonable manager would recognize that there is inherent strategic value in the Web portal outsourcing alternative. If the alignment with the company’s strategic direction makes the Web portal initiative a better choice, even if some of its more intangible benefits (such as increased customer satisfaction) cannot be directly attributed to any internal budget reduction and/or are supported by benchmarking data, a senior manager with vision and strategic objectives would choose the Web portal alternative.

Many of the major outsourcing decisions are less clear. Organizations that seek to assess and quantify the costs and benefits of outsourcing investments to determine the economic impact are often frustrated by the various murky definitions of tangible and intangible benefits. However, the tangibility or intangibility of a benefit is not as important as:

- The uncertainty inherent in its prediction;
- The degree to which it has a direct, measurable, economic effect; and
- The way in which it is evaluated.

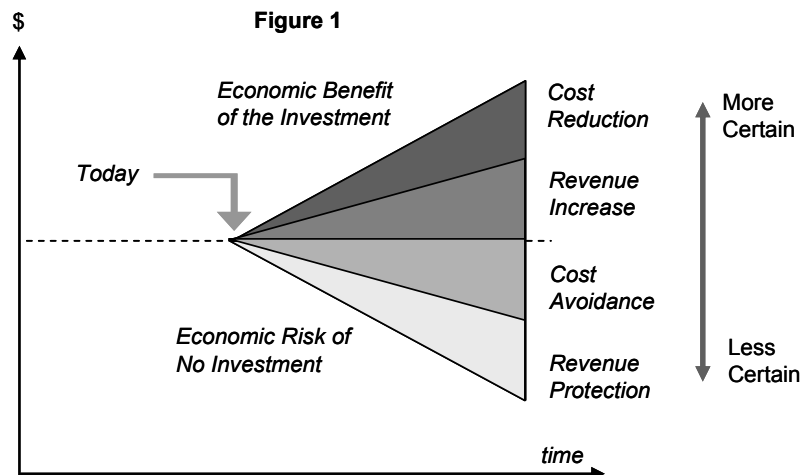
These three elements – uncertainty, causation, and evaluation – each have their role to play in the valuation of an outsourcing benefit, and should be taken in order to ensure a consistent logical process.

An executive once asked a group of managers to write down what they thought it was the definition of an intangible benefit. Not surprised with the results, the executive found out that all the answers were different. One person said that intangible benefits are the things that cannot be touched and tangible are the ones that can be touched, such as physical things. Another person said that intangibles are the revenue related benefits, and that cost reductions are the tangible benefits. Another person said that intangible benefits cannot be measured, and that tangible benefits can be measured; and so on—all the definitions of intangible and intangible benefits were different. We can find two persons spending hours arguing about what intangible and tangible benefits are, and they may never agree; that is why Glomark-Governan provides this process, which includes selected portions of Glomark-Governan’s Economic Value Creation™ (EVC™) methodology, to assist in assessing the economic value of any outsourcing benefit, including tangible and intangible benefits.

Uncertainty

Uncertainty in the forecast of a benefit's effect is the first characteristic in the analysis and assessment of outsourcing benefits. Refining the definitions of tangible and intangible ultimately results in placing the benefit along a continuum defined at one end by the "certain" and at the other by the "uncertain". Examine, for instance, Glomark-Governan's framework in which benefits are grouped into four categories (see figure 1 in page 3):

- **Cost reductions**, such as reduction in headcount or materials, are very predictable and tied directly to a budget line item.
- **Revenue increases**, such as increased sales or price, are still predictable, but less certain, and find their place in line items in a sales forecast.
- **Cost avoidance**, such as a reduction in the growth of budget item, are less predictable and are seen in future budgets.
- **Revenue protection**, such as retained market share in the face of new competition or new marketplaces, is least predictable and is found, if at all, in a marketing forecast.



While it is essential to organize the benefits of a proposed investment into these four categories during the investigation phase of an analysis—such as in the beginning of a Business Case preparation—this sorting also serves to array benefits along a uncertainty continuum that begins with “more certain” at the top and ends with “less certain” at the bottom.

Unsurprisingly, this classification also generally reflects the comfort level with which individuals view a benefit. Lower-level managers tend to focus on the certain (the ones seen as tangible), while senior managers are more willing to allow for some level of uncertainty (the ones seen as intangible) if the benefit is in line with the organization's strategic direction and has sufficient analytical grounding (that is, the uncertainty is understood and accounted for). We will see how this is evaluated.

Causation

As indicated above, there is another, equally important, aspect to a benefit; that is the degree of causation between the operational benefit and its economic impact. If, for example, outsourcing an IT Server requires less maintenance, then a resulting decrease in help desk costs and decrease in systems administration can be tied directly to the outsourced IT Server. These have a direct cause and effect relationship (less uncertainty on its prediction). However, the improved outsourced IT server may also have a less direct, but no less important, effect on the end users' productivity (more uncertainty on its prediction). Generally, what is considered a tangible benefit will present a more direct cause and effect relationship and the ones considered as intangible benefits will have a less direct relationship. Degree of causation is, then, another continuum, or axis, along which benefits can be arrayed.

Uncertainty versus Causation: a resolution

Uncertainty and causation are key elements in assessing the economic impact of an intangible benefit. The application of a representative "uncertainty element" to an expected benefit allows for the uncertainty inherent in its prediction. The degree of causation must also be accounted for through a further adjustment in the forecasted impact. Before doing this, however, attention must first be paid to the variable used to measure the benefit's economic impact (a.k.a. measured assumption, or key performance indicator). Each quantified benefit must have at least one measured variable—that is that factor or assumption that can be tracked after implementation to determine if the expected operational effect was met.

A case study illustrates this variable selection process:

Outsourcing a call center will provide several benefits. Among these is the better allocation of incoming calls among the operators. This will reduce the amount of "dropped calls." More calls received should directly result in more sales. The variable that results in the economic impact of this benefit, then, is the number of dropped calls, which affects the revenue realized through these new sales.

The rigorous application of this sort of process will nearly always produce a measurable assumption. If it does not, then it can be assumed that the proposed benefit—tangible or intangible—cannot be quantified in economic terms. Therefore, a key element for quantifying any intangible benefit is determining a way to measure the benefit. If it can be measured, then it can be quantified in economic terms.

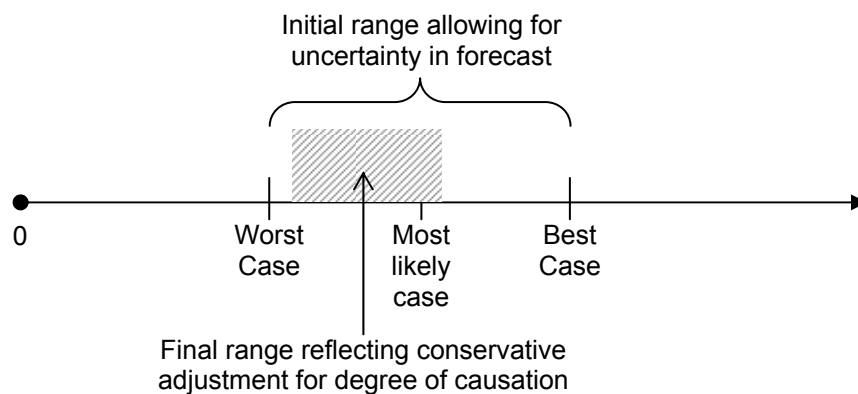
Before the economic impact is defined, this variable must be adjusted to reflect uncertainty. This "constituent of uncertainty" is derived through what we call "a scenario analysis" that applies knowledge and reference (i.e., benchmarking data) to the uncertainty. The application of the results of this analysis to the variable provides an expected range of results, generally represented by the use of "best case", "most likely case", and "worst case" values. These results generally widen as one approaches the bottom, more uncertain, end of the continuum. The outcome is a range representing a more objective quantification of the economic impact of the benefit.

In the same manner, consultants, managers and analysts should provide for the directness of cause and effect, as in this continuation of the outsourcing call center example:

Better call allocation will also reduce “on hold” time. Being on hold is annoying; reducing on hold time will increase customer satisfaction. Generally, a happy customer returns to buy more, and will be less sensitive to price. This will result in more sales at higher prices.

However, external factors, such as the economy, competitor actions (e.g. a new and much better product), or any other external factor, can have a significant, negative (or positive) impact on a forecasted improvement. As this gap between cause and effect widens, so does the potential for inaccuracy in the benefit’s forecasted effect. It is prudent, then, to make a final, conservative adjustment to allow for this risk (see figure 2, in next page), although some account for this through the use of non-financial metrics as discussed below.

Figure 2



Assessing outsourcing intangible benefits also requires a careful investigation of links between the technical, the operational, and the economic effects of the benefit. The result provides a sound framework for identifying the measurable variable needed for the economic quantification. As a simple example:

- **Technical benefit** – an on-line sales force Web service enables sales professionals in a company to produce reports with key content designed for executives in their accounts.
- **Operational benefit** – with the new reports available, the sales representatives can increase the number of meetings with senior managers in their accounts
- **Economic benefit** – an increase in meetings with senior managers will increase the close-rate. The close rate (number of orders closed as a percent of proposals presented) is the measured variable that can be used to define the benefit formula (means of economic quantification).

Use of Benchmarks

Use of benchmark data is beneficial—it assists in understanding the cause-effect relationship of outsourcing benefits. Benchmarks reduce uncertainty and risk. However, it is important to consider that enforcing the use of benchmarks in all the benefits in a Business Case has some issues. Benchmarks are found when outsourcing projects have been deployed for a while. This becomes a dilemma for strategic investments that enable market leadership, because if a company has to wait for benchmarking data to be available prior to making a strategic investment decision, then the competitors may take advantage of a new available outsourcing initiative and gain market share.

In addition, benchmarks are mostly found and based on data that is internally-controllable or internally measured, such as in cost reductions; but generally benchmarks are not easily available for externally-driven benefits, such as the ones related to revenue increase or revenue protection; because the outcome of these benefits is highly influenced by external factors.

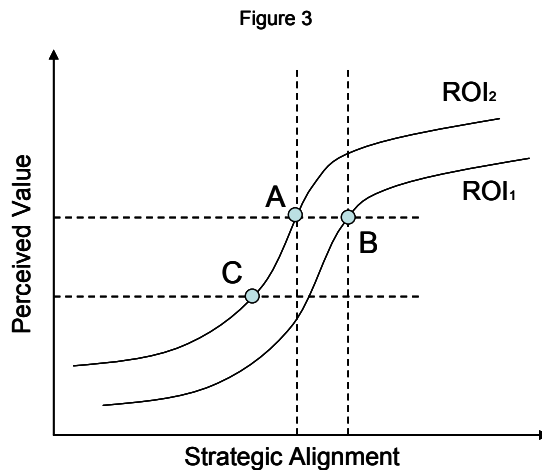
Analysts and market leaders agree that with the economic recession behind, companies are looking for growth again and are taking risks to increase revenue, create new products, and penetrate new markets. If a company makes all its investment decisions, including outsourcing, using Business Cases that are only supported by benchmarking data, then a good number of opportunities for growth and market leadership can be missed.

This illustrates the point that when generating outsourcing Business Cases, business practitioners, including outsourcing providers, should not be afraid to quantify tangible and intangible benefits without benchmarking data. Various techniques (available in the Glomark-Governan Genius software tools), such as scenario analysis (as mentioned earlier) can assist in the economic forecast and risk assessment in order to factor the uncertainty in the outsourcing benefits' estimations. When outsourcing benchmarking data is not available, it is suggested to consider the uncertainty of the forecast by increasing the range between the worst case and best case values in the forecasted improvements.

Evaluation

Although this process is sufficient to quantify the expected impact in the form of a forecasted range of financial values, observation shows that it is often insufficient to evaluate or compare all the benefits. As in the case of “an energy-savings solution versus the Web portal,” management is often quite willing to discount a very tangible financial measure in favor of less tangible measures, such as business alignment, synergies, branding, and other non-economic indicators. Although these outsourcing indicators may seem subjective, this seeming tolerance for ambiguity actually reflects the objective values embodied in a strategic direction.

The interaction between the “strategic value of outsourcing” (or strategic alignment) and financial values can skew the final evaluation to the extent that outsiders may think beyond reason. However, this interaction actually takes place within well-defined parameters (see figure 3, below).



Here, a non-financial metric, in this case “strategic alignment”, interacts with a financial metric, in this case “return-on-investment” (ROI), to affect “perceived value”. Given two constant financial returns (ROI in this case), shown by lines ROI₂ and the lesser ROI₁, we see that although point B is located on a line indicating a lower rate of return, its perceived value is the same as A because of its better strategic alignment. In the same way, point B has a much higher perceived value than C, despite delivering a lower financial rate of return.

Examining the upper and lower levels of the figure reveals an interesting pattern of behavior. At a certain upper level, increases to strategic fit add little additional perceived value. Likewise, increases from lower levels of strategic fit are similarly non-productive. There is a “sweet spot” in which small adjustments to an offering can radically increase perceived value.

Valuing Multiple Projects

Technology and outsourcing spending is a significant factor in an enterprise’s cost structure, but also an important enabler of revenues. Outsourcing cost and capabilities are ever-changing as new technologies arrive and existing technologies mature. In a turbulent environment, managers must establish a consistent and complete framework for establishing which outsourcing projects best fit the enterprise’s desire for return, tolerance for risk, and business goals.

Maintaining an optimal balance of risk, return, and strategic direction in the acquisition and management of an outsourcing and technology portfolio requires organizations to obey a consistent and complete process for assessing individual projects and the complete portfolio. Business Cases for each outsourcing project are the foundation of this process; they provide a forecast of possible economic and financial returns. The organization’s internal risk factors should be identified and applied to derive a range of probable outcomes and to identify certain influential variables in those outcomes. Next, the portfolio must be reviewed as a whole to rank the projects by return, risk, and strategic alignment. This ranked list is then laid against resource constraints to identify a range of possible portfolios. Finally, these portfolios should be plotted by risk and return to find the optimum portfolio for a given level of risk or rate of return. When diligently applied, this process gives managers a consistent measure for disparate technologies and outsourcing initiatives and a firm foundation for the application of their strategic direction.

Risk of Outsourcing Initiatives

Corporations use various methods for assessing the risk of outsourcing projects, and evaluate the uncertainty of the forecasted benefits; the depth of their investigations varies widely:

- Scenario analyses (such as the one in the Glomark-Governan Genius Pro tool) include most likely, worst case, and best case scenarios for any or all of the assumptions, benefits, costs and ROI measures in a Business Case.
- The Total Risk of Ownership (TRO™) model from Glomark-Governan (also included in the Glomark-Governan Genius Pro tool) provides an estimate of the potential economic impact of not doing the investment.
- The Monte Carlo simulation (included in the Glomark-Governan Genius Analyzer) determines the overall economic impact of uncertainty on the bottom-line of the Business Case. Often, corporations perform an accompanying sensitivity analysis to determine the individual economic impact of each assumption, benefit and cost.
- Outsourcing Business Cases are about understanding the interactions and balance between outsourcing costs, benefits and risk—reducing risk by assessing it prior to an outsourcing decision, and comparing the risk of different alternatives in scope and implementation strategies. The comparison of multiple Business Cases (or multiple scenarios of the same Business Case) helps in selecting the outsourcing alternative that has the best value and lowest risk (capability included in the Glomark-Governan Genius Compare tool).
- Outsourcing is about “risk mitigation”. A risk taxonomy assessment (included in the Glomark-Governan Genius Analyzer) can help in the identification of the variable(s) that can drive the financial return to an undesirable result; as well as to risk-adjust all the assumptions based on risk categories (i.e., vendor experience, maturity of the outsourcing initiative, internal resistance, et cetera).
- Balanced scorecards (such as the one included in the Glomark-Governan Genius Track tool) are a good way to manage projects successfully. The scorecard approach tracks key performance indicators (KPIs) during and after project implementation, allowing the project team to take prompt actions if necessary, and minimizing the chances of project failure.

Conclusion

In assessing the economic impact of an outsourcing benefit, the classification of the benefit as tangible or intangible is not as important as understanding the predictability of its measurable effect and the degree to which it causes that effect. Key to the evaluation of this uncertainty is the application of knowledge, historical and reference (benchmark) data to generate a scenario analysis, in which results are applied to the proper variable to derive an expected range of results. Furthermore, the forecast must be adjusted to reflect the degree of causation between the outsourcing benefit and its effect. Finally, managers often discount these hard results in favor of softer, but as important, non-economic “strategic values of outsourcing”.

About Glomark-Governan

Glomark-Governan helps outsourcing providers and buyers assess the value of outsourcing solutions by giving them the methodology, training, advisory and software tools they need to effectively assess risk and economic value. Glomark has tested and refined the Economic Value Creation™ (EVC™) methodology for more than a decade, bringing to market a proven, complete solution that allows buyers and vendors to organize an outsourcing project, define each component's value, and quickly create situation-specific Business Cases. The suite of Glomark-Governan Genius software tools allows vendors and buyers of outsourcing do from simple to comprehensive TCO, TBO and TRO studies of outsourcing initiatives.

To find more information or locate a Glomark-Governan office near you, please visit www.glomark.com, or contact our main office in the United States at (614) 761-2400.

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