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Keep It In-House or Outsource?

Performing a cost analysis for a
business process outsourcing decision

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The Big Decision

When a business process becomes a costly, cumbersome distraction from your organization's core product or service, the question often arises: "Should we outsource it?"

It's a question that applies to any number of non-core business functions: mailroom management, data entry, document processing, contact center services, accounting, payroll, etcetera.

When considering the possibility of turning over one or more of these functions to a business process outsourcing (BPO) provider, there are numerous risks and benefits to weigh. Some of these—such as potential cost savings—are easier to understand and identify. Other risks and benefits may be less tangible and difficult to quantify.

Regardless how you proceed to make a case for outsourcing, a best "first step" is to perform a cost analysis to determine whether it makes financial sense to keep a process in-house or turn it over to a BPO provider. It's important to remember that a cost analysis is not simply a matter of comparing the current annual cost of your process to bids from BPO providers.

This white paper presents an improved approach to cost analysis by measuring the differential costs—the costs that can be avoided by outsourcing the service—and comparing them to the costs of outsourcing. The approach is adapted from Cost Analysis and Activity Based Costing for Government¹, and is intended to provide a basic introduction to performing a cost analysis for outsourcing decisions. The analysis involves a multi-year period (typical with large outsourcing contracts) and discounts future costs to their present value.





Performing a Cost Analysis

The analysis can be broken down into four basic steps:

- **Step 1:** Clearly define the business process your organization would like to outsource.
- **Step 2:** Calculate the in-house costs that could be avoided by outsourcing.
- **Step 3:** Calculate the total costs of outsourcing.
- **Step 4:** Subtract the costs of outsourcing from in-house costs to determine savings.

For the cost analysis example presented in this paper, a three-year contract period is used. Steps 2 through 4 are repeated for each year, and future costs are discounted to their present value for an accurate calculation of potential cost savings.²

Step 1: Clearly define the business process your organization would like to outsource.

It is critical that the services you are considering outsourcing are clearly defined, and that all workflow steps are identified and understood. A clear understanding of all steps in the process will help produce an accurate cost analysis, and ensure that the services proposed by BPO providers match your business outcome expectations.

For a complex function, such as an inbound-outbound mail center and associated downstream workflows, including the processing of claims, applications or other forms, it is helpful to engage the services of a business engineer to document all steps in the process. A business engineer can also redesign the process to remove wasteful steps, helping to improve efficiency and reduce costs even before potential cost savings from outsourcing enter the picture.

Step 2: Determine the in-house costs that could be avoided by outsourcing.

After the business process is clearly defined, it is time to identify and calculate the costs your organization would avoid if it outsourced the process. To start, first itemize all the costs related to the process, including direct costs (salaries, equipment, supplies, etc.) and indirect costs (general administration and internal services).

Do not include "sunk costs," which are costs that have already been incurred and cannot be recovered. Decision-making based on a cost analysis should instead focus on avoidable future costs, which in this case are costs that can be eliminated by outsourcing the process.

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Next, itemize all the in-house costs that could be avoided if the business process is outsourced.

In many cases, these will be different from the total costs—for example, if your organization retains a part of the business process, or if your organization maintains a level of management over the process.

Example 1 illustrates steps 2 through 4 for a single-year cost analysis. Example 2 extends the analysis over a three-year period and discounts the costs in year two and year three to their present value.

Example 1: A single-year cost analysis

Costs of an in-house business process			Costs of outsourcing	
Cost Categories	Costs	Costs Avoided by Outsourcing	Cost Categories	Costs
Salaries/Wages/Benefits	\$500,000	\$450,000	Vendor's Bid Price	\$450,000
Furniture/Equipment	\$100,000	\$100,000	Contract Administration	\$30,000
Supplies	\$200,000	\$150,000	Transition Costs	
Software	\$20,000	\$10,000	• Unemployment compensation	\$2,000
Facility Rent/Lease	\$100,000	\$75,000	• Accrued vacation benefits	\$15,000
Utilities/Communications	\$25,000	\$20,000	• Severance pay	\$15,000
Total	\$945,000	\$805,000	• Penalties for early lease termination	\$10,000
			Revenue from Sale of Unused Assets	+\$10,000
			Total	\$512,000

\$805,000	-	\$512,000	=	\$293,000
In-House costs avoided by outsourcing		Total costs of outsourcing		Cost savings of outsourcing

Step 3: Determine the total costs of outsourcing.

With in-house costs calculated, it is time to determine the total costs of outsourcing the business process. The starting point, of course, is the BPO provider's bid price. In addition, as Example 2 illustrates, your organization may have costs for administering the outsourcing engagement, such as processing change orders and monitoring and evaluating the provider's performance. In year one, there will typically be costs involved in the transition to outsourcing. But there may also be some revenue opportunities, such as income from the sale of unneeded furniture, equipment and supplies.

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Example 2 also reflects an annual decrease in the price of the BPO provider's services. In some cases, a provider may offer a year-to-year reduction in pricing as part of its value proposition, because it is confident it can identify opportunities to continually improve the process. The provider passes on a portion of the resulting cost savings to its customers.

Example 2: A multi-year cost analysis

Costs of an in-house business process

Cost Categories	Current Annual Costs of Service	Costs Avoided by Outsourcing		
		Year 1	Year 2	Year 3
Salaries/Wages/Benefits	\$500,000	\$450,000	\$450,000	\$450,000
Furniture/Equipment	\$100,000	\$100,000	\$100,000	\$100,000
Supplies	\$200,000	\$150,000	\$150,000	\$150,000
Software	\$20,000	\$10,000	\$10,000	\$10,000
Facility Rent/Lease	\$100,000	\$75,000	\$75,000	\$75,000
Utilities/Communications	\$25,000	\$20,000	\$20,000	\$20,000
Total	\$945,000	\$805,000	\$805,000	\$805,000

Net present value (NPV) of costs avoided by outsourcing **\$2,367,957 = \$805,000 + \$789,216 + \$773,741**

Costs of outsourcing

	Year 1	Year 2	Year 3
Vendor's Bid Price	\$450,000	\$440,000	\$430,000
Contract Administration	\$30,000	\$30,000	\$30,000
Transition Costs			
• Unemployment compensation	\$2,000	\$0	\$0
• Accrued vacation benefits	\$15,000	\$0	\$0
• Severance pay	\$15,000	\$0	\$0
• Penalty for early lease termination	\$10,000	\$0	\$0
Revenue from Sale of Unused Assets	+\$10,000	\$0	\$0
Total	\$512,000	\$470,000	\$460,000

Net present value (NPV) of costs avoided by outsourcing **\$1,423,764 = \$512,000 + \$460,784 + \$450,980**

\$2,367,957	-	\$1,423,764	=	\$944,193
In-house costs avoided by outsourcing		Total costs of outsourcing		Cost savings of outsourcing



Step 4: Subtract the costs of outsourcing from in-house costs to determine savings.

Example 2 illustrates the result of the final step of the cost analysis, which is to calculate the cost savings that outsourcing is expected to deliver. If the numbers show that outsourcing can significantly reduce the cost of the business process, then your organization will be able to justify the next steps toward outsourcing, such as engaging with the Business Engineering department of a BPO provider, or crafting a Request for Information or a Request for Proposal to obtain bids for outsourced services.

Further Considerations

Of course, a cost analysis is just one tool—albeit a very useful one—used to create the overall framework for an outsourcing decision. In regard to cost assumptions, it is important to keep in mind that there will always be a degree of uncertainty. To deal with uncertainty, the cost analysis can be broadened to include a scenario analysis, with numbers reflecting pessimistic, optimistic and most-likely outcomes. Another approach would be to apply a certain threshold margin to the calculated savings (at least 10 percent savings, for example) to decide whether it is worthwhile to pursue an outsourcing engagement.

In addition, there are non-financial risks and benefits that come into play in the decision to outsource. On the risk side, they include human resource issues, such as a corporate culture resistant to outsourcing. Benefits include returning your organization's focus to its core product or service, and eliminating the cost drain and distraction of non-core services. Again, it may be helpful to consult with business process outsourcing specialists to understand the best practices and considerations of an outsourcing engagement.

Developing a full understanding of all the objectives and options involved in an outsourcing decision can be a complex and time consuming process filled with uncertainty. By performing a cost analysis as a first step, you can help assure that your organization will move ahead with a clear and confident view of outsourcing's potential.

“Outsourcing benefits include returning your organization's focus to its core product or service, and eliminating the cost drain and distraction of non-core services”



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Notes

1 Michel, R. Gregory. Cost Analysis and Activity-Based Costing for Government: GFOA, 2004. Print.

2 Year 1 is assumed to be "now," so costs associated with that year are not discounted to their present value. For Years 2 and 3, a discount rate of 2 percent was used to calculate the present value.

About DATAMARK

DATAMARK, Inc. is a leading business process outsourcing company specializing in high-volume digital mailroom management, document processing/document management, contact center services, and process improvement consulting for Fortune 500 companies and other large enterprises.

Headquartered in El Paso, Texas, DATAMARK employs nearly 2,000 people in its U.S., Mexico and India facilities.

For more information, visit www.datamark.net.