PERSPECTIVE

Outcome Based Pricing:
A Win-Win Pricing Approach For FAO Services

– Saurabh Arora

Abstract

In today's competitive Finance & Accounting Outsourcing (FAO) environment where most providers boast of an end-to-end suite of offerings, pricing the deal smartly can often be a differentiator between winning a deal and coming a close second.

Post the financial crisis, both the buyers and the providers are looking to extract maximum value out of their outsourcing contract and an outcome based pricing structure provides them with a unique opportunity to do just the same. While most people recognize this potential, how to successfully execute this structure however still remains a bit of an unknown.

This paper focuses on some of the characteristics of an outcome based pricing structure and shares some best practices in order to successfully execute this arrangement for long term mutual gains.

**While this paper focusses on FAO Services , the learnings however can be replicated across other segments as well

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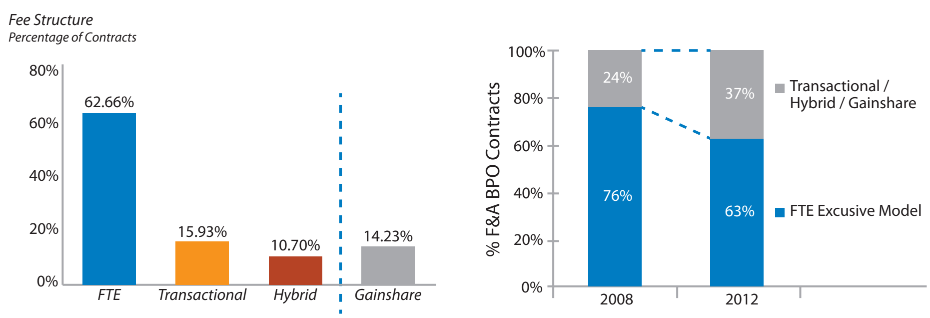
Overview and market trends

BPO service providers often offer flexible pricing options to enable the client to choose a structure which best fit their organizational needs and business value drivers. Traditionally the most common pricing structures offered by FAO service providers can be divided into the following four categories:

Fixed Term Project Pricing	FTE Pricing (Input Based Pricing)	Transaction Pricing (Output Based Pricing)	Gain sharing (Outcome Based Pricing)
A pre agreed lump-sum fee is charged for completion of a well defined task Suitable where the requirement is of a temporary nature and scope of work can be clearly defined	Proposed to start with this model Suitable when the volumes are stable and can be easily forecasted Payout volumes fixed with dedicated resources aligned Fractional FTEs requirements will be rationalized	Transaction based pricing is mostly adopted for functions where there is an inherent fluctuation in the volumes Transaction Resource units to be defined, measurement methodologies determined and agreed upon Could have a mix of dedicated vs. A non dedicated resource model	Pricing is based on a pre agreed business outcome Normally a fixed+variable component where the variable component ranges from 20-40% based on collected $ tiers Resource agnostic model

As the market has matured and the client expectations have evolved, gone are those days where the client was happy with having adequate number of resources available to support its business. These days clients expect service providers to put some skin in the game – share some risks. Due to this the market is noticing a strong shift of client preference towards an outcome based contractual pricing structure – i.e. a structure where the payment to the service provider is based on achieving certain pre-agreed business outcomes. Since outcome based pricing is still a maturing structure, most contracts currently start with traditional Full Time Employee (FTE) based model and progress towards outcome based or combination of pricing models (Hybrid model) as the relationship matures.

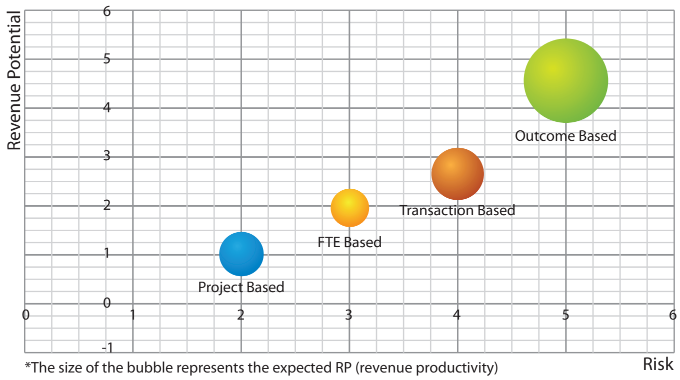
FAO Remains Dominated by
FTE Models While Gainsharing is Becoming an Increasingly Attractive Option for Buyers



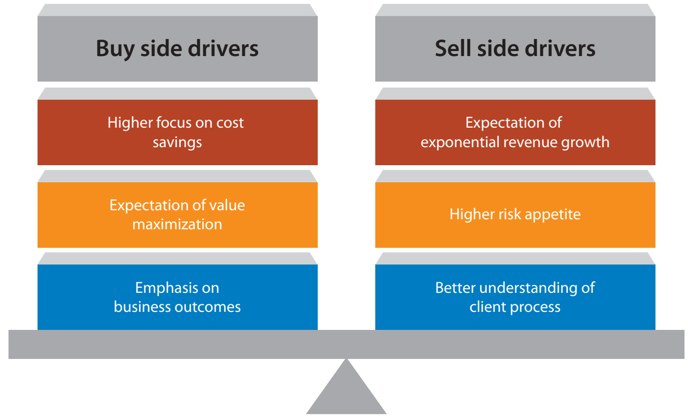
Source: HFS Finance and Accounting BPO Market Landscape - 2013

Why move to outcome based pricing model?

Deciding a pricing structure is impacted by various factors like the nature of the engagement, predictability of volumes, driving factors of the outsourcing engagement and the risk appetite of both the customer and the service provider. While high level fitment of each structure basis the nature of work has been explained in the table at the beginning of this discussion, it is also important to get a view of the potential revenue each pricing structure can generate and the risk associated with them. The Project/ FTE structure can be considered as the safest and most predictable. From a service provider's perspective, this structure guarantees a particular amount of revenue and the possibilities of revenue fluctuation are slim to none. From a client's perspective, it is a predictable structure which facilitates clear visibility of payments and enables them to budget accordingly. It however does not give any guarantee of business outcome optimization – at best the contract may have some penalties associated with pre-defined SLA's. The transaction based structure is somewhere a middle ground, since there is a payout volatility based on the transactions completed. It does not provide any impetus for business outcome maximization. On the outset, the outcome based model may seem more risky. However, it is also one which provides the potential of creating the maximum benefits for both parties -clients in terms of business outcomes and service providers in terms of absolute revenues and high revenue potential (RP).



*The size of the bubble represents the expected RP (revenue productivity)



With the FAO service providers becoming more risk taking and wanting to maximize their RP as much as possible, the move towards an outcome based pricing model seems like a natural progression. Maturity in existing relationships has also provided them a much deeper understanding of the client business which further builds the case for promoting an outcome based pricing agreement. The customers on the other hand are also actively seeking contracts with more emphasis on assurance of business outcomes as well as risk sharing with the service provider.

Potential challenges and relevant best practices

The benefits of an outcome based pricing model are apparent, which makes one wonder why the adoption of this model is still very low in the market. The reality is that the finance and accounting middle management of most providers (and sometimes clients) still shy away from engaging in an outcome based contract due to the following factors:

Potential Pitfall	Pitfall Description	Best Practice
Timing	Tendency to jump in too early into an outcome based model without complete understanding of the client business (either client or supplier driven)	Define an appropriate warm up period (in case of a new engagement) to enable the supplier to develop an understanding of the process and do appropriate baselining.
Trust	Client's lack of trust in the supplier's ability to generate business outcomes. This can be due to the following factors - The service provider has limited understanding of the clients' business drivers and context - Client perceives the providers approach as tactical - Service provider's ability to execute process improvement initiatives - Service provider's myopic focus on only the outsourced process - Very high stakes at the client end in case the outcome is not met	In order to mitigate the above, the service provider has to develop a strong communication rhythm with the client and encourage the following specific interventions: - Develop a separate innovation board which focusses on outcome enhancement through process transformation - Have a strong reporting and governance structure - Encourage participation in client business updates and strategy meetings wherever possible
The need to let go	Service providers want to have control over the procedures to maximize output, however client is hesitant to let go of existing process	Jointly define a mutually acceptable process with built in checks and controls – set up a regular rhythm to review process efficiency and improve process accordingly
Difficulty in quantifying outcomes	In a lot of F&A processes – especially processes like Accounts Receivable (AR) it is difficult to decide how an outcome can be calculated which is both manageable to consistent	Upfront agreement on operational definitions is critical. Outcomes should be specific and measurable, the calculations of benefits of direct and indirect benefits should be agreed upon

Strong dependencies on internal client organizations	Since only a part of the entire business process is outsourced, there are often multiple dependencies. E.g. Payment approval time in Procure to Pay (P2P) impacts the "Payment on time" business metric.	All similar dependencies to be clearly identified and reverse Service Level Agreements (SLA) to be agreed upon with the client. Also a clear recourse action has to be agreed upon in case the SLA is not met. E.g. De-scoping etc.
Scoping	There is lack of clarity in the appropriate scope which would be used for outcome calculation E.g. In AR, will disputed accounts be in scope or out of scope.	Scoping exercise is the most critical part of this arrangement. It is critical that all potential impacts are evaluated and exact scope agreed upfront.
Risk	The risk is quite high for both parties.	It is a good practice to define payout caps at both ends – this will avoid extreme volatility and help hedge some risk.
Centralization of pricing responsibility with the pricing teams	In most provider organizations the pricing process is managed by a separate pricing team which often sits in the corporate finance organization. This team may not have the required domain depth to build an outcome based pricing structure.	This structure needs to be created together by the pricing team/the domain expert and the process expert since this structure requires depth on all the three areas.
Win-Win mindset	It is critical that both the service provider and the client take on a win – win approach to create mutual value.	This structure should equally enhance business benefits for the client along with maximizing revenue for the provider – It will fail in the long term if it is skewed to benefit only one of the parties.

Conclusion:

An outcome based pricing structure has tremendous potential to benefit both the client and the service provider, however can be detrimental if not done right. Unlike the traditional models, an outcome based model has certain inherent uncertainties based on factors not completely in control of the providers. E.g. Impact on the debtors ability to pay due to various micro/macro-economic factors. The key of this model is to create an inclusive approach with strong communication and governance – it's a simple principle of risk and reward.

About the Author

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Saurabh is the O2C practice leader for Infosys and has over 14 years of experience in developing complex client solutions and creating sustainable, mutually beneficial business models. In his current role he is responsible for developing best in class O2C offerings with a world class service framework. Saurabh is a Masters Finance and Six-Sigma certified professional with a strong understanding of the European Market along with deep domain knowledge of the Order to Cash cycle.

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