Total Cost of Ownership

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In an effort to lower cost, enhance productivity and better manage risk, companies are constantly searching for technologies, which will enable their organizations to attain these goals. Oftentimes, companies are successful in this pursuit. In fact, the unprecedented technology-driven productivity gains of the 1990s are credited by many as a primary reason for the longest peacetime expansion of the U.S. economy in history.

But does the acquisition of technology automatically bring about higher productivity at a lower cost? For every success story, there is undoubtedly a story of costly and/or failed implementations or bankruptcy. WebVan comes to mind, but that's another story for another day.

How can companies determine if the introduction of technology will or has resulted in economic gain? Total Cost of Ownership (TCO) can help provide the answer. Invented by the Gartner Group, TCO is a methodology for identifying all costs incurred for the life of technology. It tends to be expressed as a total dollar value.

In the areas of HR, payroll and benefits administration, we can modify the TCO concept to express TCO as an annualized cost for delivery of services to employees. This TCO will include both the technology costs such as:

- Implementation,
- Upgrades,
- Maintenance,
- Hardware, and
- Software, etc.

The TCO will also include the administration costs such as:

- Labor costs including payroll, tax and benefits;
- Non labor costs including facilities, supplies, training, expenses, telephone, computer, etc.; and,
- Outside service costs such as consulting and outsourcing services.

A ground-breaking study commissioned by ADP in 2003 calculated the TCO of end-to-end payroll and implementation and maintenance of HRIS for large companies administering payroll and HRIS in-house. Two follow-up TCO studies looked at TCO for companies that outsource payroll and also the TCO for in-house and outsourced benefits administration. The author of this article designed, analyzed, and compiled the results of all three studies. Much has been written about these studies, and white papers are available that provide the detailed results.

In this article, we will highlight a few of the results, discuss some of the non-published findings of the studies, and discuss how these findings can be used by practitioners to aid in the decision-making process.

Buy versus Build

When evaluating the introduction of technology to a process, often the first decision an executive encounters is the "buy or build" decision. The cost of new technology can be daunting when compared to departmental budgets. Executives must consider whether the size of their own organization is large enough to spread the costs. The smaller an organization, the harder it is to justify large expenditures. In addition to size, one must consider scalability, future use, commitment of the organization, historical ability to deliver large-scale IT projects, etc.

When looking at the results of the TCO studies, certain results give us insight into this evaluation. The studies provided three key findings for companies implementing in-house solutions that should be considered here:

- The technological vision is most often not achieved.
- The cost of maintenance and upgrades is greater than anticipated due to the decreasing useful life of software.
- For certain company size groupings, the average cost of payroll administration is higher for companies that introduce employee self-service technology.

Losing the Vision – Shelfware

There are four HRIS modules that we consider core to the HRIS suite: core HR, base benefits, compensation and regulatory reporting. By definition, 100 percent of companies deploy core HR. Most other companies deploy the other three as well. There are nine other modules we typically consider part of the HRIS suite. These are modules such as succession planning, recruitment and performance management. Over half of the companies that own seven of these other modules hadn't implemented them at the time the study was conducted. Nearly half of the companies that owned the other two modules hadn't deployed them.

For so many companies to buy software that ends up sitting on a shelf is a surprise. While the pervasiveness of shelfware may have many reasons, it is certainly indicative of at least one thing: *companies pursuing in-house solutions are not achieving the full implementation vision held at the time of purchase.*

Increased Costs – The Upgrade Treadmill

Most companies we've encountered depreciate the capital expense associated with software implementation over a three-year period. Some, however, use a five-year depreciation schedule. Interestingly, we found that the average upgrade for payroll and HR systems is coming every 18 months. In fact, some companies are actually upgrading within a year of initial implementation.

Anecdotally, we see that the business cases originally developed by these companies did not anticipate the need for upgrades in the first three years. Clearly, costs are higher than anticipated. This puts strain on the organization, and may also be a key reason for the abundance of shelfware: *Needed financial and human resources are deployed on upgrade activity instead of second phase module implementations*.

Increased Costs as a Result of Technology

The first TCO study for payroll and HRIS captured costs for 181 companies. Of these companies, 75 had self-service applications for employees. These self-service capabilities allow employees to view payroll information and make changes to personal information.

Interestingly, companies with about 8,000 – 14,000 employees had lower average TCO for payroll than companies without employee self-service. However, companies with fewer than 8,000 employees or more than 14,000 employees actually experienced, on average, higher payroll TCO after the introduction of self-service capabilities.

For the smaller companies (under 8,000 employees), it would seem that the cost of implementation can't be spread across a large enough base in order to benefit from the technology spend in this case. Also, the process time savings may not result in actual FTE headcount reduction. An important note is that for the individual companies introducing self-service, there may have been a reduction in cost from their previous environments, but the study findings beg the question: was the introduction of self-service the optimal solution?

More shocking is that the larger companies (with over 14,000 employees) also experienced higher costs on average. Without further data, we can't know with certainty why this occurred. It is observable, however, so we can postulate and learn from the phenomenon.

The postulations below are definitely not the opinions of IHRIM, and will not necessarily win the author many fans in the IT community, but speaking solely from experience, three general observations may be made about large companies that could explain why the introduction of self-service technology results in a higher average payroll TCO:

- Corporate oftentimes has limited ability to force process change and headcount reduction at the divisional or field level. As a result, technological enhancements that are designed to improve field productivity and reduce headcount achieve the former, but not the latter.
- Departments within large company corporate structures tend to operate in silos. Information technology departments frequently find themselves setting strategic direction instead of "operationalizing" strategy and providing the tools to achieve it. As a result, the introduction of new technology, while having the potential for producing productivity gains, falls short because of a lack of coordination with the functional administration areas. Training, change management, and true organizational change fall short of the goals.
- In larger organizations, IT projects can quickly take on a life of their own, resulting in over-engineering. The limited-scope self-service applications turn into broader-vision portals that carry heavier maintenance demands. The add-on functionality produces "gee whiz" response, but limited ability to produce a return-on-investment (ROI) through productivity gains or head count reduction.

While anecdotal in nature, the above observations should serve as a reminder to decision-makers when faced with buy versus build decisions. Taken together with the previously noted data-driven study findings, it should serve as a reality check for executives as they ask themselves: "What is the likely outcome of implementing in-house solutions at our organization?"

The Outsourcing Decision

For many companies, the quest for successful technology deployment results in the outsourcing of the administrative functions the technology is meant to support. In the HR field, it has produced a huge market for payroll, HR and benefits administrative outsourcing. Through outsourcing, companies have historically been better positioned to administer a 401(k) plan, for instance.

In the current environment, companies are outsourcing more and more HR functionality everyday. At the least, they are turning to hosted systems providers for HRIS functionality, and at the other end of the spectrum, we see end-to-end processes being outsourced.

In all cases, it seems companies are successfully accessing current technologies through outsourcing. The findings of the TCO studies support this observation. In the area of payroll, 41 percent of companies provided self-service capability. In the outsourcing environment, basic self-service for viewing pay information has become a staple, making companies over twice as likely to offer self-service if outsourcing.

In the benefits administration area, outsourcing results in a 19 times greater probability of offering self-service for annual enrollment assistance and ongoing life event change processing.

But here again, at what cost does the outsourcing come? Our studies have proven that, on average, companies can save 30-35 percent on their total costs through outsourcing. But these are averages.

Within the study groups, we find that there are companies that outsource and still experience high costs. All of these companies have one thing in common: After outsourcing, a significant portion of TCO is internal cost. In fact, some companies in the study group saw 80 percent of their TCO as internal cost!

This begs the question: *If you are outsourcing, why are your internal costs still so high?*

The answer is that there are right ways and wrong ways to implement an outsourced solution. The change management challenges that an organization faces implementing in-house solutions do not disappear merely through outsourcing. In most cases, change management becomes an even greater challenge. Forcing process change and staff reduction or redeployment becomes even more critical because the costs of outsourcing become duplicative if organizational change is not accomplished. From our experience, the business case for outsourcing is always predicated at least in part on being financially neutral or better. This assumes change will take place. Where change does not occur, outsourcing will likely be viewed as a failure

TCO and the Decision-Making Process

So how can companies use TCO concepts to help them make informed and wise decisions? Total cost of ownership is the base upon which all ROI calculations may be made. The power of TCO is that it takes all costs into consideration. The impact of a change in technology (insourced or outsourced) will be felt across the organization. If the financial impacts in other departments and budget areas are not considered, one can unintentionally raise total costs.

By using TCO to baseline and benchmark current cost, then using TCO to project future costs in differing environments, an organization can develop a more accurate ROI calculation.

A full "before and after" TCO analysis also provides the milestones for cost reduction, whether they be staff reduction, changes to licensing fees, hardware purchase, consulting spend, etc. Also, a much greater level of accountability can be established, which is particularly important if outsourcing is the chosen path.

About the Author

Donald Glade is president and founder of Sourcing Analytics, Inc. Founded in 2003, Sourcing Analytics analyzes, quantifies, recommends, and monitors solutions that enable companies to optimize their HR, benefits, and payroll service partnerships. Work spans financial analysis, ROI calculation, business case development, governance and process re-engineering and improvement. He has 25 years' experience including senior positions with PricewaterhouseCoopers, Arthur Andersen and Watson Wyatt Worldwide.

He is a frequent public speaker and has addressed such groups as the American payroll Association, the Society for Human Resource Management and the International Society for Certified Employee Benefits Specialists. He is also a regular contributor to the leading industry blog: SystematicHR.com and holds a B.A. in Economics & Political Science from Duke University.