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## Executive Summary

The Indian IT industry has been enjoying a boom time since its inception in early nineties. The industry successfully weathered recessions whenever it occurred and bounced back to its normal growth path. However a newer challenge is causing worry to most of big IT service providers.

The as-is business model of IT service providers is Application Development and Maintenance; their revenue is effort based, i.e., more the number of people working, the more the revenue. This is termed as “Linear growth”. Though the upper levels have not been tested, one is sure that beyond a particular number, adding more people will cause the overheads to increase. Presently TCS is leading this linear growth and has more than 160,000 employees on its payroll.

Today other key factors which are driving IT service companies to break the linear pattern of growth can be summarized as below:

- ✓ Organizational complexities of managing an ever-increasing workforce
- ✓ Difficulty in implementation of organization wide processes
- ✓ Rising man power costs & high employee turnover caused by demand outstripping the supply of software professionals
- ✓ Rising Operational Costs caused by increased cost of operations in cities
- ✓ Pricing pressures caused by competition from international IT providers IBM, Accenture and others who have increased their offshore presence and pricing pressures from the client due to recent global recession

- ✓ Currency movements exerted by global financial situation

**In this paper we will examine the Outcomes based service delivery model which we believe holds highest potential to help companies achieve their non-linear growth objectives.**

Outcome based service delivery model encompasses a partnership model between the customer and the service provider where the success of the engagement and corresponding payout to the provider hinges on the direct or indirect measurement of actual business results for the buyer.

In this paper, we will draw on the comprehensive project work we did as part of EPGP course and interviews we conducted with various companies on their non-linear initiatives and especially any outcome based project model implementation.

In the first section, we will examine the role of Outcomes based service delivery model as non-linear driver and define what we mean by outcomes based on the Program Logic Model.

In the second section, we will provide theory work on Outcomes based project management and how it differs from regular project management theory practiced. We also provide service delivery framework based on performance based contracting practiced in Aerospace industry.

The third section details about different pricing models categorizing them into Input-based, Output-based and Outcome-based and delve into depth on different models of Outcome-based pricing models.

In the final section, outcomes-based outsourcing is detailed providing the enablers for success. Also the advantages to providers and customers are shared to provide a perspective from both sides. The focus of this section is the contracting process for which the guidelines are provided.

### **Non-Linear Initiatives**

IT services industry has been experimenting with various initiatives in its quest to achieve non-linear growth. Mostly the IT Products are thought of as an answer to the challenges posed by linearity. While products are proven to provide means for non-linear growth, there are many opportunities in services itself. Some of most prominent initiatives are given below.

#### **❖ New Delivery Models**

New Delivery Models such as managed services where the service provider is completely responsible for delivery of end to end services with business level SLA's under agreed contract, flex delivery model which leverages economies of scale by consolidating similar type of work across multiple clients etc

#### **❖ IP's and Solutions**

Typically software that is internally developed to automate a particular business process or aspect of product development and can be reused across engagements

#### **❖ Alternate Commercial Models**

Pricing models of delivery and revenue initiatives which are tied to Output delivered by service provider or business outcome of the client, the prominent among them being outcomes based service delivery model.

Apart from the above, there are many other initiatives but we believe that Outcomes based service delivery model holds the greatest potential to help companies achieve their non-linear objectives.

### **Outcomes based Service Delivery Model as Non-Linear Driver**

Software is the intellectual capital output of the codified knowledge of a programming team. Unfortunately, there does not exist a valid or reliable measure to value software. The trend has been to align pricing to the aspects that buyers realize value from. Vendors need to understand the value they provide to their customers and create a price structure that aligns pricing with actual value realization, and more importantly facilitates the business objectives of the service. This in itself can act as a strong non-linear growth factor for IT service providers.

Outcome based service delivery model as alternate commercial model is most suitable for IT Service companies to help achieve the non-linear growth and also move up the value chain.

Following are some of the reasons:

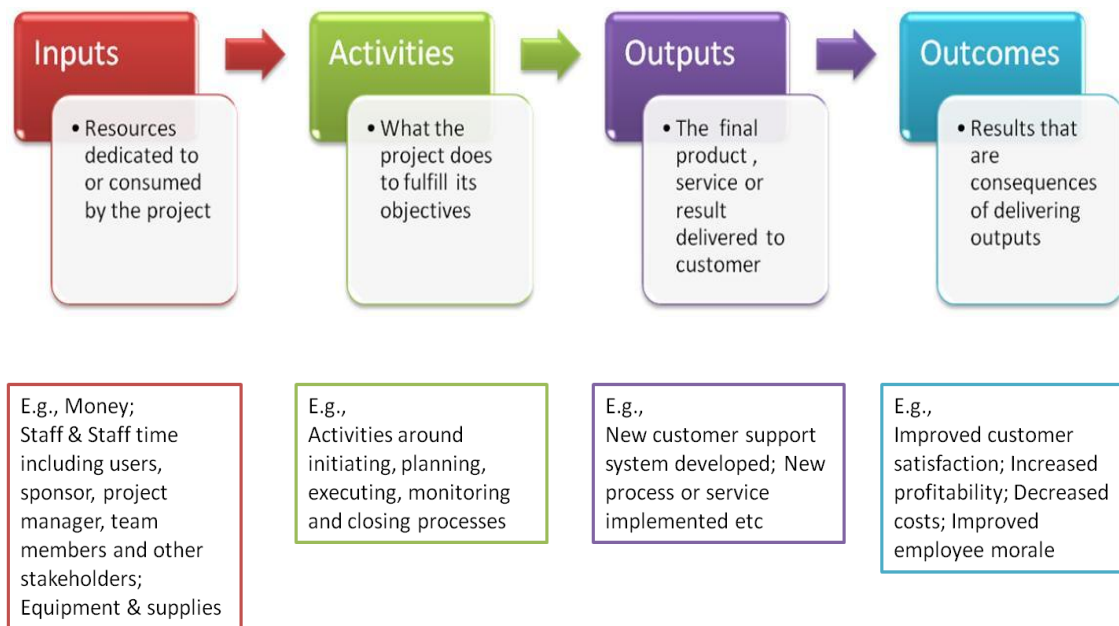
- a) In an outcomes based model, the revenues of the service provider are contingent on the delivery of actual business outcomes and not on the ability to provide skilled manpower or on the ability of the deployed manpower to deliver IT output. This breaks the traditional linearity in the organization's growth trajectory.
- b) In an outcomes based model of engagement, the customer and the vendor act as partners and share financially the value added throughout the outsourcing relationship.

This provides longevity of relationship in the non-linear revenue pipeline. Thus, once started, an outcomes based delivery model can prove to be self-sustaining in nature.

- c) Since the customer is only interested in the business results delivered, the onus of delivering those results within minimum cost lies with the service provider. Thus within the limits of the engagement contract, the profitability of the service provider is limited only by the efficiency and productivity of the deployed manpower and processes.

### What is “Outcome”?

Our definition of “Outcome” is based on the **Program Logic Model** (shown below):



*In our definition, “Outcomes” refer to actual business results like revenues, profitability or cost savings which directly or indirectly impact the top line or bottom line of a buyer. Outcomes could be measured in terms of direct business oriented measures (e.g. revenue increase, cost savings*

*realized) or indirect process oriented measures (e.g. delivery timelines or quality of deliverables, which in turn affect the actual business results).*

Outcome based service delivery model encompasses a partnership model between the customer and the service provider where the success of the engagement and corresponding payout to the provider hinges on the direct or indirect measurement of actual business results for the buyer.

### Characteristics of Outcome-based models

In this section we attempt to capture the characteristics and some of the advantages of an outcome based service delivery model based on different criteria of process or business orientations.

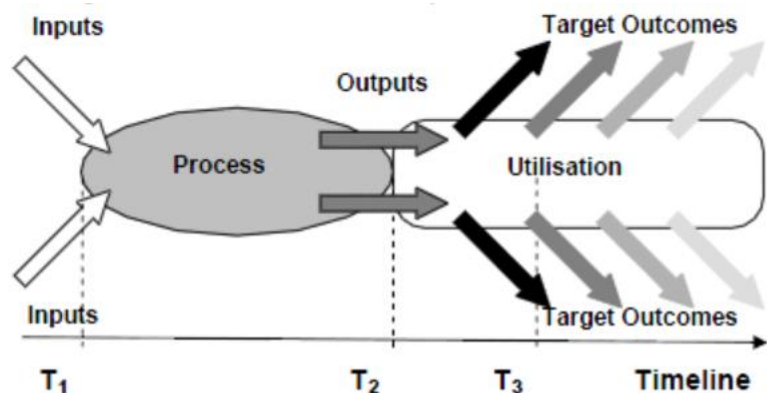
- ✓ Sharing of business risk between buyer and service provider – both working towards the same goal.
- ✓ Forces the supplier to deliver best value as results are rewarded and not efforts.
- ✓ Outcome based models can act as a major differentiator for progressive service providers.
- ✓ In practice, process-oriented outcomes are primarily deployed rather than business oriented outcomes for a variety of reasons. Examples of Process oriented measures are meeting deliverables, SLA's and deadlines. Examples of Business oriented measures are business results such as revenue, profit and cost efficiency.

## Outcome based Service Delivery Model

### Outcome based Project Management Theory

The common perception of a project is based on the IPO (**Input-Process-Output**) model. Here the project is considered complete once the delivery is made as per pre-determined time, cost and scope. This is an incomplete

approach as it does not consider the benefits accrued from the project over a longer period of time. Hence, the new outlook towards the definition of a project



is based on the ITO (**Inputs Transformed into Outcomes**) methodology.

Under the new model, accountability for outputs remains with the project manager, but there is question of accountability for target outcomes. Since benefits are not delivered or realized by the project manager and team, there is a need for a new project role to be accountable for benefit realization. A project owner, who is the agent of the project sponsor, should lead an outcomes realization process to ensure benefits are secured.

### Outcome based Service Delivery Framework

Performance Based Contracting (PBC) can be used where the service provider is contractually held to performance requirement, which reflect high value outcomes, such as systems readiness and supply chain efficiencies. In software maintenance projects, PBC can provide an



opportunity to use Reliability & Maintainability (R&M) metrics as objective measures of contract outcomes which, when used as the basis for contractor payments, ensures the convergence of contractor and provider behaviors to better achieve these outcomes. Typical R&M measures include Availability, Reliability, Maintainability and Supportability.

This could be achieved by a 4 step process:

1. Determination of Outcomes
2. Selection of metrics
3. Setting targets for each of the metrics
4. Design of Payment Regime that support the performance metrics

In the below section we will present the four steps to Performance Based Contracting in detail<sup>1</sup>.

We assume a typical application maintenance outsourcing engagement where service provider has contractual responsibility to maintain a portfolio of applications. 'System' as used in this section is either one application or a group of applications required to perform tasks to satisfy certain business need.

To give an example, a new business and underwriting system used by business users in an Insurance Company needs multiple applications such as new policy entry application,

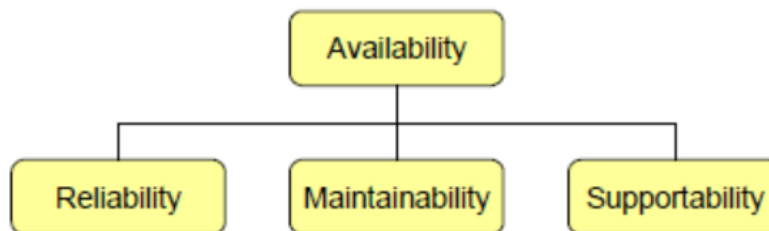
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<sup>1</sup> Based on work done in Aerospace industry by Debbie Richardson and Andrew Jacopino - Use of R&M Measures in Australian Defence Aerospace Performance Based Contracts

underwriting application, reporting application to meet the needs of insurance sales person to know if the policy can be accepted with given risk by the company.

**STEP-1: Determine Outcomes**

Outcomes can be looked as aspiration statements of business priorities underpinned by system performance characteristics. Accordingly the characteristics of Availability, Reliability, Maintainability and Supportability provide a superstructure for developing outcomes in application maintenance projects.



The following outcomes seem to align with business priorities in any typical application maintenance engagement.

Outcome	Explanation
<b>System Readiness</b> <b>(Availability)</b>	The state of readiness of the system to perform specified task
<b>Task Success</b> <b>(Reliability)</b>	A measure of the ability of the system to perform its specified task under stated operating conditions
<b>Light footprint</b> <b>(Maintainability)</b>	Minimizing the ongoing support needed required for application to increase its robustness

<b>System Assurance (Supportability)</b>	Confidence in provision of right resources required to provide needed services at the right place, at the right time and with the right quality and to sustain that support over time
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### STEP-2: Selection of Metrics

Having established the outcomes, the next step is to assign simple, meaningful and measurable metrics. The metrics selected should meet the following criteria

- ✓ should be unambiguous in the information provided
- ✓ clearly linked to the delivery of the outcome and
- ✓ for which data sources are immediately available

With above criteria in place, the following metrics are chosen to measure the outcomes

- Available Applications – to measure system readiness
- Mean Time between failures – to measure reliability
- Demand Satisfaction Rate – to measure system assurance

### STEP-3: Setting Targets

The target for the metrics (e.g. MTBCF – Mean Time Between Critical Failures) is to at least maintain the values delivered by the contract, as tendered by the successful contractor, in response to the original user's requirement and need.

**STEP-4: Payment Regime**

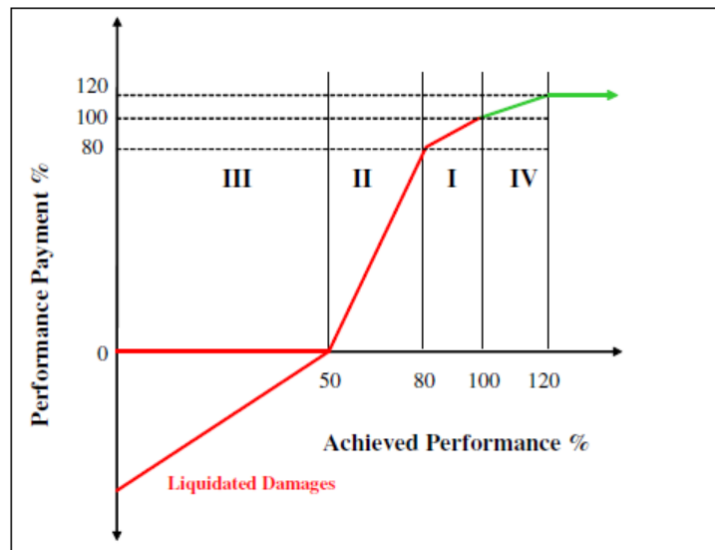
The fourth step in developing performance based contracts is to design a payment regime which supports the performance metrics. Payment can be used to focus contractors on performance priorities, as contractors are highly sensitive to conditions which effect their payment and cash flow.

This model recommends withholding a portion of the contract price and making it subject to the performance level achieved. The amount at stake is then subdivided by the weighting given to the performance metrics. The performance for each of the metrics is then analyzed and the value that Client places on the level of performance is judged.

This approach is shown in the alongside Figure which depicts bands of performance corresponding to the value (in terms of

% of performance payment) the client places on particular levels of performance.

As the Figure shows, the Client recognizes that there is likely to be small variations in performance in any



review period and therefore payment for 80 – 100% of the required target for any metric would attract 80 – 100% of the amount at stake for the metric. However, 50% of the required

standard – for example 50% of the number of applications required on line – is considered to be of negligible value and may result in opportunity costs for Client as business users cannot be usefully employed. Accordingly, no performance payment would be made. Infact, more severe contractual remedy of Liquidated Damages may be imposed at this point to further deter contractor performance in this band.

### Observations

#### **Financial and Technical Risk**

Contractors have both financial and technical risk in this model. The financial risk was attributed to contract payments being withheld against achieved performance. Although client was attracted to the logic of withholding a certain portion of the contract price until the service had been provided to the standard specified, this increased the uncertainty of cash flow to the contractor and its shareholders. As a result, the contractor was looking for opportunities to balance this risk against opportunities to make money above the contract price (i.e. incentives). While incentives can be usefully employed to achieve objectives not easily contained by performance metrics (such as to drive continuous improvement), care should be taken that they do not undermine the value for money presented by the core performance structure.

Technical risk was also identified by contractors. In particular, contractors were reluctant to warrant reliability of system under maintenance if there were heavy modifications made to the applications.

**Adequate Separation of Client Processes/Actions from Contracted Outcomes**

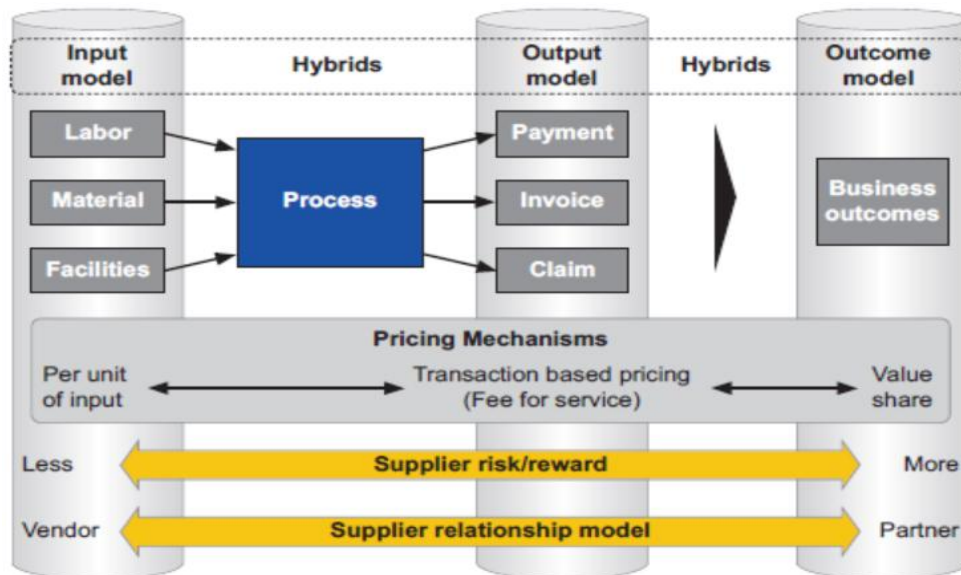
Linked to contractor's assessment of risk, is the concern that this model does not adequately represent the separation of responsibility in contracts where privacy and control dictate that client staff are employed in key roles in supporting production environment. Contractors argue that this involvement is beyond the contractor's control but highly influential on the ultimate effectiveness of the service.

## Pricing Models in IT Outsourcing

Pricing is one of the key determinants of any contract and more so in IT Outsourcing where the results are intangible in most cases. As outsourcing became mainstream for many companies, there has been increased focus on innovation to deliver better value. Newer pricing models started evolving along with the maturity of the outsourcing industry. This section details about the different pricing models and innovation happening in this area.

The pricing models can be broadly classified as under<sup>2</sup>

- ❖ Input Based
- ❖ Output Based
- ❖ Outcome Based



<sup>2</sup> [http://www.steria.co.uk/assets/4\\_ASSETS/pdf/00434.pdf](http://www.steria.co.uk/assets/4_ASSETS/pdf/00434.pdf)

## Outcome Based Pricing

Since its inception, the IT services industry for a long time followed the traditional **input** based models of pricing. Here the price of the service is calculated based on the amount of effort or time that is expended in the project such as Time & Material contract. Though Input Based models bring cost savings, primarily because of labor arbitrage, they do not have sufficient cost control mechanism on vendor. Hence, instead of measuring input, some companies switched to measuring quantity of work produced or **output** and not inputs that go into it, with the models such as Milestone based model, Transaction based pricing model etc.

**Outcome** based pricing is about getting paid for delivering a desired business result to a customer and not so much about what goes into making that happen<sup>3</sup>. This can take the following forms:

- Revenue Sharing
- Gain Sharing
- Success based pricing
- Performance based pricing (Risk-Reward)

In outcome based contract, customer is not interested in how much it will cost for the vendor to deliver the product; the customer is only interested in a particular outcome for which he is willing to pay good money.

This also means that the customer and the vendor share financially the added value as partners throughout the outsourcing relationship. Besides sharing gains they also share the risks

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<sup>3</sup> <http://business.outlookindia.com/printarticle.aspx?263717>



associated with the business relationships. In order to properly share gains, the vendor and the customer must first align their goals. The level of rewards can then be linked to the tangible business results such as lower costs, new revenue or profits etc. Realistically set incentives will improve the cooperation, service levels, productivity, profitability and commitment on both sides.

Unlike in the Time and Material pricing model where service providers can maximize their revenue by increasing man hours of work or fixed price contract where productivity improvement can help, outcome based contracts entail a entire change in mindset. According to NASSCOM, although less than 5% of current offshore contracts are outcome based, the trend is set to pick up in the near future.

The following key parameters<sup>4</sup> can be used by a vendor to check the favorable/unfavorable results before adopting the outcome based pricing model for an engagement.

Return on Investment (ROI): The proposed ROI for the client should be higher than that of other competitively priced bids for them to justify their adopting an outcome based pricing model. Also vendors outcome based fee would normally be tied to the clients ROI improvement so this measurement is an important parameter to assess the vendor's profitability from the engagement

Risk Appetite: For most outcomes based pricing models, the fee will be based on the results achieved. If the service offering performs well and exceeds expectations, the fee will be on the higher end; on the other hand if the service offering fails to meet the performance benchmarks,

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<sup>4</sup> Based on <http://mindshareconsulting.com/realities-value-based-pricing/>

the vendor will be required to forego some of his expenses for providing the service. Therefore there is inherent risk associated with this pricing model and the vendors risk appetite and their financial strength in incurring loss should be considered for this type of engagement

Sensitivity Analysis: An analysis of the best case and the worst case situations of outcome and their corresponding impact on profitability should be assessing before finalizing the contract.

Financials: Typical outcome based pricing models do not involve upfront payment for covering the fixed costs. Also the case conversion cycle will be longer than other traditional pricing models in which case vendor has to assess his short term financial situation and working capital issues else may run into cash flow issues.

### Example of risk-reward sharing model in an outcomes based contract

The below simple example illustrates how the commercials in an outcomes base contract could be structured. Vendor A is contracted in a testing services engagement by an Insurance client.

The baseline data for the testing services engagement is as follows:

Description	Release 1	Release 2
Project Price	450000	1550000
At risk amount (7.5% of project price)	33750	116250

There were two primary risk factors envisaged in this engagement: Schedule Variance and Quality of delivery. This is a true risk-reward model of engagement where the risk and reward models are quantified as below:

<b>Risk Model</b>			
<b>Schedule Variance</b>			
<b>Schedule Variance</b>	<b>% At risk amount</b>	<b>Release 1</b>	<b>Release 2</b>
Between 10 and 15 days	10%	3375	11625
Between 16 and 20 days	20%	6750	23250
Between 21 and 25 days	25%	8438	29063
> 25 days	50%	16875	58125
<b>Defect density variance</b>			
<b>Defect Density in %</b>	<b>% At risk amount</b>	<b>Release 1</b>	<b>Release 2</b>
Between 3 and 5	10%	3375	11625
Between 5 and 7	20%	6750	23250
Between 7 and 10	25%	8438	29063
>10	50%	16875	58125

<b>Reward model</b>			
<b>Schedule Variance in %</b>	<b>% At risk amount</b>	<b>Release 1</b>	<b>Release 2</b>
Between -10 and -15	10%	3375	11625
Between -16 and -20	20%	6750	23250
>-20	25%	8438	29063

### Outcome based Outsourcing

Apart from contribution to non-linear growth, there are multiple advantages which have driven the move from an earlier input or output based model to an outcomes based delivery model<sup>5</sup>.

#### Advantages for the service provider

- ✓ Strong differentiating factor from other competitors providing similar services
- ✓ Higher margins

<sup>5</sup> <http://www.outsourcing-center.com/2010-01-what-companies-need-to-understand-about-switching-to-outcome-based-approaches-in-outsourcing-article-37264.html>

- ✓ Greater opportunity to develop collaborative and consultative long term trust and relationship with customers
- ✓ Enhanced scope of gaining bigger share of wallet and IT spend
- ✓ Greater employee productivity and motivation, as the employees are now not rewarded for putting in hours but for achieving results

### Advantages for the customer

- ✓ Pay only after achieving measurable business outcomes, minimal upfront investment
- ✓ Lower overhead in terms of manpower needed for project management and team selection
- ✓ Greater certainty of achieving sustained growth and profitability
- ✓ Transfer of risk to the vendor

### Enablers for change to outcome-based outsourcing

As is obvious, the success of an outcomes based delivery model is contingent upon a number of factors.

- ✓ The relationship between the service provider and the customer must have reached a certain level of maturity and understanding before the customer can entrust the provider with achieving business outcomes
- ✓ The customer itself should have enough maturity to be able to adapt to the new or changed processes that might be necessary to realize the actual outcomes
- ✓ The outcomes against which the payments are contingent must be clearly identifiable and measurable

- ✓ The improvement in the business outcomes that are to be measured should be clearly attributable to the outputs delivered by the vendor.
- ✓ Customer should be ready to partner with the vendor to build technical and business knowledge IP (Intellectual Property) that can be leveraged across businesses

Outcomes based delivery models work best in startup situations or where the IT organization/system of the customer is in its infancy or undergoing a turnaround/ revamping phase. Then the service provider gets the opportunity to manage the entire value chain and thus build software that is geared towards achieving measurable business outcomes. With customers that already have a mature IT system in place, it becomes more and more difficult for the vendor to manage the entire value chain that contributes towards achieving the final business outcome. Hence, it becomes difficult to compensate (or penalize) the vendor based on achieved (or not achieved) outcomes because the customer does not know whether the outcome was achieved (or not) because of what the software vendor did or due to changes in some other part of the chain.

As an example, let us consider the case of one of the service providers who entered in an engagement with a large telecom service provider for process optimization and cost structure rationalization. All the software had been built and ready to be deployed when the entire process was halted by a regulatory policy rollout delay by the department of telecommunication. Now the customer cannot achieve the envisaged outcomes but the vendor has already incurred huge investments to build the software. How is the vendor to be compensated or penalized in this situation?

There are three catalysts that will enable buyers and service providers to widely adopt an outcome-based approach over the next few years<sup>6</sup>

- 1. Outsourcing is now evolving beyond savings through labor arbitrage and focusing on new and different ways to create value, including synergies between functions as key drivers of value.**

The approach is changing especially in areas where the buyer has a significant fixed cost. This is forcing buyers to get more creative because so much of their current spend isn't in people, so there's not as much savings available through labor arbitrage. The value in an outcome-based approach depends on transformation through new innovations that a provider needs to bring to a specific function.

The customers will no longer pay huge fees for "consulting" and "improving" processes; instead, the providers will find it imperative to transform the processes to drive better output and outcome.

- 2. Providers are now investing and innovating around invigorating their capabilities in and around new value creation.**

Leading service providers are now building the capability for a value-creation approach which will enable more buyers to adopt it as the basis of their arrangement going forward

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<sup>6</sup> <http://www.outsourcing-center.com/2010-01-what-companies-need-to-understand-about-switching-to-outcome-based-approaches-in-outsourcing-article-37264.html>

Part of this involves building platforms and simplifying processes. But it also requires that providers gain deeper knowledge of a customer's industry. The industry knowledge and domain knowledge will play an important role in achieving business outcomes.

The capability for delivering more value outcomes necessitates providers not being tied to a linear group. It will call for a change in the mix of the consulting and technical teams. Providers will have to change their complete game in order to help their customers change the outcomes.

In outcome-based approaches, the outsourcer doesn't just provide services; it also takes responsibility for achieving a different business outcome on a different level of balance-sheet performance. For example a project migrating all of a buyer's finance and accounting functions with pricing based largely on the provider's performance in improving the buyer's working capital position.

However outsourcing arrangements focusing on outcome objectives can only be successful when both parties are collaborative and take a partnering approach.

### **3. Deepening of the partnering approach to outsourcing relationships.**

Outcome-based sourcing creates a greater level of dependency on the service provider hence it is extremely important that the buyer understand the level of risk the provider must take to help the customer achieve the desired business outcome. This will only work if it is a complete partnership type of relationship and if there is strong governance and relationship management with senior leaders on both sides working together.

Over the next few years the delivery of transactional services will become a hygiene factor and providers will increasingly contribute to the customer's business strategy.

### Contracting is the key

Shared risk/reward can be applied to input, output and service-based contracts, for example by tying some portion of the payment to achieving a specific milestone. Outcome Based Contract (OBC) is a form of shared risk/reward, but not all shared risk/reward contracts are outcome-based. OBC will not work on all situations. The conditions under which OBC is suitable are as follows:

- ✓ Enough trust between client and supplier to allow a partnership approach
- ✓ Clearly measurable outcomes
- ✓ Manageable complexity with few factors that influence outcome
- ✓ Commitment of business to required changes

Additionally, outcomes should have the following attributes:

- ✓ **Influencable** - able to be influenced by a player
- ✓ **Controllable** - only influenced by one particular player
- ✓ **Measurable** - able to be measured
- ✓ **Attributable** - able to be attributed to one particular player (i.e. proved that only one particular player changed it)
- ✓ **Accountable** - something that a particular player will be rewarded or punished for.



## Conclusions

Parties thinking of striking an Outcome Based Contract need to ensure they enter the agreement with shared values, a stable and clear baseline against which the outcomes can be measured, a willingness to operate with openness and transparency, a standardised means of measurement and a clear set of accountabilities. OBCs will only be successful if both parties work to mitigate external risks, conduct full and ongoing due diligence, ensure effective governance, conduct regular mutual checkpoints and maintain aligned incentives.

Since both parties have invested in the engagement, hence the termination clause chalked out in the contract becomes critical. In the unfortunate situation of premature termination of the contract, the vendor should have a minimum guaranteed return to recoup (even if partially) its investments.

In an outcomes based contract, the partnering parties are entering into an agreement based on certain premises. If the premise changes, then the risks associated with the change should be explicitly spelled out in the contract. For example, if the outcome to be measured is revenues then the contingent premise or assumption of macro-economic stability of the country should be taken into consideration.

## Appendix

### 1. Further Readings: Outcome-based approach to Scoping

Using outcome based scoping (OBS) project leaders develop a more complete understanding of how to meet the problem domain objectives, not just deliver a working software solution. First the problem domain scope needs to be developed. From that foundation, the software domain scope model is developed. OBS further structures the scoping effort by decomposing the concept of scope into two dimensions: intent (representing the goal) and blueprint (representing the resources required to meet a specified goal).

For detailed understanding of an outcomes based approach to Scoping, the following attached article can be referred.



OBS.pdf

### 2. Further Readings: Outcome-based approach to Risk Assessment

- Identifying stakeholders during requirements engineering
- Identifying stakeholder influences in the project
- Project's impact on stakeholders
- Assessing risks posed by potential negative responses of stakeholders

For detailed understanding of an outcomes based approach to risk assessment, the following attached article can be referred.



OB\_Risk\_Assessment  
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