

**(h) copies of financial advice from PricewaterhouseCoopers, dated 26 May 2000, and Deloitte Touche Tohmatsu, dated 10 May 2000, on the methodology used to calculate savings.**

Attached are copies of financial advice from PricewaterhouseCoopers, dated 26 May 2000, and Deloitte Touche Tohmatsu, dated 9 May 2000, on the methodology used to calculate savings.

Private and Confidential

Mr John Bridge  
Director  
Office of Asset Sales and IT Outsourcing  
Burns Centre  
28 National Circuit  
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26 May 2000

Subject: IT Outsourcing – Financial Evaluation

Preamble

We refer to our previous advice wherein we were asked to provide an opinion on the most appropriate method of comparative financial evaluation of information technology procurement options for OASITO, acting on behalf of various Commonwealth Government agencies. The procurement options included:

- retaining ownership and other responsibilities on a business as usual basis ("Business as Usual"); or
- outsourcing these matters to a third party contractor ("Outsourcing").

In that previous advice we were instructed by OASITO to assume that the procurement decision and related costs beyond the initial term of the 5 year Outsourcing contract were not predictable. Accordingly we considered that an equitable comparative evaluation should equalise the options at year 6 to a position where no assets or liabilities remained in the agency.

After further analysis, we consider that it may be possible to establish a measure of predictability in relation to year 6 procurement options. For example, such predictability could arise if the outsourcing strategy is based on strategic objectives or policy requirements that are expected to continue beyond the initial evaluation period and other evidence supports the view that a procurement decision, once taken, is unlikely to be reversed. We would suggest that in cases where there are reasonable grounds to expect that the initial procurement decision might be repeated at the end of the evaluation period.





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9 May, 2000

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By Facsimile: 02 62089250

Dear Rod,

## TREATMENT OF ASSETS AND LIABILITIES

I refer to you letter dated 27<sup>th</sup> April 2000 that followed our discussion of the same date in relation to the treatment of assets and liabilities in completing a financial assessment of an outsourcing initiative.

In your letter you outline three principles that are adhered to by OASITO in conducting financial assessments. In the manner you have stated those principles, we are in general agreement and would advise that is the basis upon which we would undertake a similar assessment.

However, in undertaking a financial assessment of an outsourcing arrangement, some of the "normal" principles that are applied are:

- There can be various views completed in relation to the financial assessment including pure cash flows, a full accrual basis or a hybrid combining key elements of both – the last one being an enterprise value of the proposed deal and taking into account such items as tax effect
- In the pure cash flow basis, it is our practice to assume business as normal throughout the proposed arrangement together with a continuing arrangement at the end of the initial period. We do not attempt to guess what the outcome will be as it may continue with the same provider, move to another provider, return in house or be a combination of all three if the basket of services is split or changed

May 9, 2000

Page 2

- In relation to existing assets, the treatment can be different depending upon the style of financial analysis being conducted. In a pure cash flow, the only item accounted for is the possible inflow of funds received from the sale of the assets. It is acknowledged that the funds to be received can be accounted for in different ways depending upon the arrangement put in place with the service provider. In comparing this against the internal baseline cash flow, it is assumed that the existing assets are a sunk cost and there is no expectation that the assets will be sold and leased back or subjected to some other form of financing
- In a similar manner, no adjustment is made in a cash flow model for what happens at the end of the initial contract period in relation to assets. The actions to be taken then are not known and should not, in our view, be accounted for – this is the key feature of the business as usual principle
- The treatment is different if an accrual basis is used reflecting an enterprise value of the proposed arrangement. Under this scenario, assets would be accounted for at the beginning, would be depreciated and replaced over the duration of the contract. This is a significantly different model than a pure cash flow and possibly reflects a more purist view of the value of the deal. This compares to the so called savings model arising from the cash flow projections which are really no more than a net savings or additional outgoings of "cash".

From our experience, we can understand how people from client organizations can expect different treatment of assets. We have found that it is necessary to have education sessions in order to fully explain the different financial models that can be developed.

We agree with you in that it is desirable to model different financial effects to help in the overall assessment.

In relation to the specific questions raised in your letter, we advise as follows:

- There are several approaches that can be employed when conducting a financial assessment of the proposed arrangement
- Where a pure cash flow model is used, the principles used by OASITO as outlined in your letter are considered appropriate
- The approach taken by OASITO in conducting a financial assessment is in line with our own methodology however we also use an enterprise accrual basis, as cash flow is just one item of an organizations balance sheet. It should be noted that this is more applicable to a private sector organization than the public sector

May 9, 2000

Page 3

- As stated above, the savings identified in a cash flow model are just that, the net cash savings or net additional outgoings of cash, nothing more or nothing less. This does not reflect the real net value gain or loss to the enterprise from entering the proposed arrangement.

] *REVISE*

We would be pleased to discuss the contents of this letter with you. The above views have been discussed with a number of the partners within Deloitte Consulting and all are in agreement with the treatment proposed.

Please note that this letter and the opinions contained therein is provided to OASITO for their use only and must not be released to any other party or organization without the consent of Deloitte Consulting.

Yours sincerely



Russell Brewer  
Principal