

Over the years, outsourcing in the public sector has become an accepted management practice. Too often, however, administrators choose to outsource when it is more economical to continue providing the service internally, or reject outsourcing when it is more economical to purchase a service from an external vendor. These faulty decisions have economic consequences that affect the efficiency and effectiveness of government organizations. Although it is generally understood that making outsourcing decisions requires accurately estimating the cost of a service or product, it is also critical that administrators consider the time horizon of their outsourcing decisions and any associated opportunity costs.

# Public Sector Outsourcing: A Modified Decision Model

Outsourcing decisions have both short- and long-term economic consequences. In the short run, much of a government's labor and overhead costs associated with a support service may be incurred whether the service is provided internally or purchased from an outside vendor. Here, the relevant cost is incremental cost. Moreover, when a government entity has fully used constrained resources, providing support services internally forces the entity to forego providing other services or programs. Hence, providing support services internally has an opportunity cost. In the short run, the relevant costs for evaluating whether a support service should be outsourced are the incremental and opportunity costs associated with internally providing the service.

In contrast, over an extended time horizon, administrators have discretionary power over their resources. For example, resources can be adjusted to meet constituents' demands for services and programs, and contractual and managerial policies governing labor and overhead resources can be adjusted to meet the entity's operational needs. Because of this discretionary power, the relevant cost for evaluating outsourcing in the long run is the total cost of resources used in providing a service or program.

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The relationship between an outside vendor's price for a service and the short- and long-run costs of internally providing the service creates four cases of outsourcing (see *Figure 1*). Each case involves assessing whether a service should be outsourced in the short run and/or in the long run.

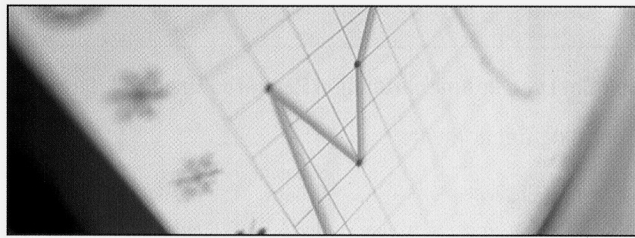
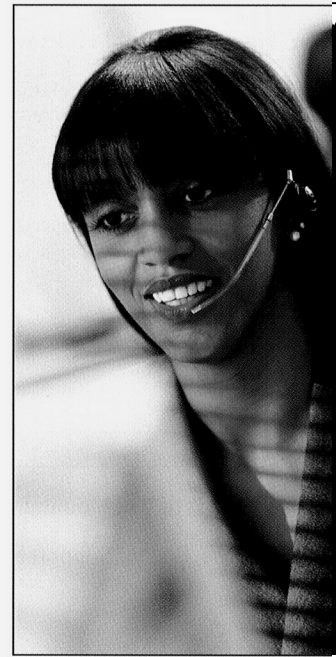
**Case One:** In this situation, the outside vendor's price for a service is less than the government's short- and long-run cost of providing the service. Therefore, the government is confronted with the need to outsource the service in the short as well as long run.

**Case Two:** Here the outside supplier's price for a service is greater than or equal to the government's short-term service cost, but less than its long-term cost. Under these conditions, the government should provide the service internally for the short run but plan to outsource it at some point in the future.

**Case Three:** This situation is similar to Case One, except that the outside vendor's price is greater than or equal to the government's long-run cost of providing the service internally but less than its short-run cost. Therefore, the government is confronted with the need to outsource the service in the short run but begin providing it internally at a later date for the long term.

**Case Four:** The final situation involves an outside supplier's price for a service being greater than or equal to the government's short- and long-run costs of providing the service internally. Under these circumstances, the government should provide the service internally in the short run as well as over the long run. Thus, outsourcing is not economical over any time horizon and should not be undertaken.

In this article, we discuss how information about the short-run flexible cost of an activity's resources and its usage of constrained resources may be integrated into a traditional activity-based costing (ABC) system to allow administrators to better assess the economic consequences of their outsourcing decisions. While the traditional ABC model provides relevant cost information for evaluating outsourcing in the long run, a modified ABC model incorporating only incremental costs and constrained resources provides information for assessing the economic feasibility of short-run outsourcing. We demonstrate that, while



the information from the two models is different, the information is complementary and can be used to provide deeper insights into the economics of an outsourcing decision.

## ABC as a Multi-Decision Model

A major improvement in determining a service or product cost is to use an ABC system rather than the traditional cost-based system. ABC is a process by which indirect costs are traced to cost objects based on factors that cause indirect costs. The use of multiple cost drivers and tracing costs at the structural level at which they are incurred enables ABC to more accurately measure the cost of an entity's output relative to a tradition cost system.

Today, many state and local governments use ABC as an integral part of their cost systems. However, an important weakness of the ABC model is that it is inappropriate for short-run resource decisions. This is true for two reasons. First, ABC reflects a long-run perspective of the cost of an organization's resources. In the short run, an activity's resources can be classified as flexible and committed. Flexible resources are those acquired as needed, such as supplies and temporary employees. Committed resources are those acquired in advance of their usage through contractual obligations.

ABC treats an activity's committed resources as flexible costs because in the long term, administrators can adjust the level of committed resources to those needed by the governmental entity. The ability of administrators to influence committed resources over the long term enables the resources to be treated as flexible costs. However, the time frame required for transforming committed into flexible costs generally takes an extended period of time.

The second reason that the traditional ABC model is inappropriate for short-run resource allocation decisions is that ABC ignores the implications of limited or constrained resources. In the near term, the committed resources of an entity's support and service activities are fixed. Therefore, the activity with the most restrictive level of resources determines the quantity of service output that may be provided. When the demand for a government organization's services exceeds its ability to satisfy the demand, the unit's most constrained activity limits further production of the service. Consequently, the use of a constrained activity forces an entity to ration its use among different social goods and programs. The benefit of the goods or services forgone from this rationing process represents an opportunity cost that affects the economics of every resource allocation decision that involves the use of a constrained activity.





**Figure 1: Possible Outsourcing Cases**

Case	Relationship of Supplier's Price to Government's Internal Service Cost	Outsourcing Implications
One	Supplier's price < Internal short-run cost Supplier's price < Internal long-run cost	Outsource short-run Outsource long-run
Two	Supplier's price ≥ Internal short-run cost Supplier's price < Internal long-run cost	Provide short-run Outsource long-run
Three	Supplier's price < Internal short-run cost Supplier's price ≥ Internal long-run cost	Outsource short-run Provide long-run
Four	Supplier's price ≥ Internal short-run cost Supplier's price ≥ Internal long-run cost	Provide short-run Provide long-run

**Figure 2: City of Mountain Brook Cost and Interdepartmental Resource Usage**

Panel I: Cost of Support and Operating Departments:

	Central Service				General Gov't	Line Dept's	Totals
	DP	HRM	Acctg	Legal	Gen Adm	Programs	
<b>Direct Department Costs:</b>							
Flexible costs	\$190,000	\$132,000	\$185,000	\$155,000	\$280,000	\$12,070,834	
Committed costs	<u>210,000</u>	<u>190,000</u>	<u>150,000</u>	<u>165,000</u>	<u>420,000</u>	<u>8,057,500</u>	
Total Cost	<u>\$400,000</u>	<u>\$322,000</u>	<u>\$335,000</u>	<u>\$320,000</u>	<u>\$700,000</u>	<u>\$20,128,334</u>	<u>\$22,205,334</u>

Panel II: Interdepartmental Resource Usage:

	Service Activity (Cost Driver)				
	DP (CPU Minutes)	HRM (Employee Contact Hrs.)	Acctg (Processed Transactions)	Legal (Consultation Hours)	Gen Adm (Number of Employees)
<b>Service Activities:</b>					
DP	10,000	50	24,800	30	6
HRM	10,800	2	64,000	65	3
Accounting	27,400	80	2,500	30	12
Legal	324	390	14,500	20	3
General Administration	24,300	400	84,000	122	15
Line Departments	<u>45,176</u>	<u>580</u>	<u>32,000</u>	<u>1,253</u>	<u>196</u>
Capacity Used	118,000	1,502	221,800	1,520	235
Practical Capacity	<u>120,000</u>	<u>2,500</u>	<u>240,000</u>	<u>1,800</u>	<u>235</u>
Unused Capacity	<u>2,000</u>	<u>998</u>	<u>18,200</u>	<u>280</u>	<u>- 0 -</u>

While the traditional ABC model is useful for long-term decision-making, the model's treatment of committed cost as a flexible cost and its failure to incorporate the effect of constrained resources make it inappropriate for short-run resource allocation decisions.<sup>1</sup> This weakness of the traditional ABC model is critical when evaluating the feasibility of outsourcing, since the time horizon for making the decision is traditionally

near term. Also, many governmental entities face resource limitations that create constrained activities that restrict their operations. This is especially true during downturns in the economy that result in declining tax revenues.

To overcome the limitations of the traditional ABC model, a modified costing model can be used. This is the traditional ABC model modified by segregating an activity's resources into flexible and

committed costs.<sup>2</sup> A cost driver rate is then computed based on an activity's flexible cost and its practical capacity. This enables the ABC model to measure an activity's short-run or incremental cost, and incorporate the opportunity cost of a constrained activity by measuring the benefit of the best alternative given up to produce a good or service. We refer to a modified ABC model based on short-run flexible and opportunity cost as an operational ABC model. While this model provides economic data useful for short-run decisions, it is not useful for long-term decisions. The traditional ABC model's long-term perspective of cost fills this void. The strengths of the operational and traditional ABC models are complementary and provide the short- and long-run measure of cost needed to evaluate the economics of outsourcing over varying time horizons.

## Complementary Strengths

The traditional ABC model and the operational ABC model reflect different assumptions about the relevance of labor and overhead resources and the capacity of an entity's activities. The validity of these assumptions is dependent, in part, upon the time horizon chosen for making resource allocation decisions. Over a sufficiently short time horizon, much of an entity's labor and overhead resources are committed costs. Therefore, the flexible cost of an activity's resources and the opportunity cost of using constrained resources represent the current cost of providing an activity's service. Accordingly, the operational ABC model measures the costs that are relevant for evaluating the economic consequences of short-run resource allocation decisions.

Conversely, over a sufficiently long time horizon, the committed cost of labor and overhead resources become flexible costs. That is, government administrators can adjust contractual obligations as they are renewed and change management policies in light of the entity's service needs. This enables administrators to adjust the supply of committed resources. The traditional ABC model measures the cost a government organization may expect to incur from service/program-related decisions over the long term. In effect, the traditional ABC and operational ABC models reflect

**Figure 3: City of Mountain Brook Inter-Departmental Cost Relationships**

**Panel I: Cost Equations:**

$$\begin{aligned}
 D &= + 10,000/118,000 D + 50/1,502 H + 24,800/221,800 A + 30/1,520 L + 6/235 G + \$190,000 \\
 H &= + 10,800/118,000 D + 2/1,502 H + 64,000/221,800 A + 65/1,520 L + 3/235 G + \$132,000 \\
 A &= + 27,400/118,000 D + 80/1,502 H + 2,500/221,800 A + 30/1,520 L + 12/235 G + \$185,000 \\
 L &= + 324/118,000 D + 390/1,502 H + 14,500/221,800 A + 20/1,520 L + 3/235 G + \$155,000 \\
 G &= + 24,300/118,000 D + 400/1,502 H + 84,000/221,800 A + 122/1,520 L + 15/235 G + \$280,000
 \end{aligned}$$

**Panel II: Simplified Cost Equations:**

$$\begin{aligned}
 + 108,000/118,000 D - 50/1,502 H - 24,800/221,800 A - 30/1,520 L - 6/235 G &= \$190,000 \\
 - 10,800/118,000 D + 1,500/1,502 H - 64,000/221,800 A - 65/1,520 L - 3/235 G &= \$132,000 \\
 - 27,400/118,000 D - 80/1,502 H + 219,300/221,800 A - 30/1,520 L - 12/235 G &= \$185,000 \\
 - 324/118,000 D - 390/1,502 H - 14,500/221,800 A + 1,500/1,520 L - 3/235 G &= \$155,000 \\
 - 24,300/118,000 D - 400/1,502 H - 84,000/221,800 A - 122/1,520 L + 220/235 G &= \$280,000
 \end{aligned}$$

**Panel III: Solution to Cost Equations:**

	<b>Flexible Cost</b>	<b>Total Cost</b>
D or Data Processing	\$275,510	\$578,253
H or HRM	\$262,641	\$584,349
A or Accounting	\$300,886	\$585,159
L or Legal	\$254,347	\$535,516
G or General and Administrative	\$ 577,936	\$1,323,791

the economic consequences of resource-allocation decisions over different time horizons. Consequently, the strengths of the two models are complementary in nature. The strengths of each model may be used to overcome limitations of the other model, which is essential for improved outsourcing decisions.

## An Integrated Outsourcing Example

To illustrate the integration of the traditional ABC and the operational ABC models, consider the city of Mountain Brook. This is a hypothetical municipality with a population of approximately 65,000. It provides programs and services typical of a city its size. It also provides public utilities in the form of waste management and water/sewer. In addition, Mountain Brook has service departments such as data processing, human resource management, accounting and legal to support its primary programs and services. The city also has a general administration department to manage its municipal operations.

The town council has placed an indefinite hiring freeze on city personnel in an effort save money. The city administrator has proposed considering outsourcing support services that can be purchased more economically from an external vendor. The city's data processing, human resources, accounting and legal departments are the support services that will initially be evaluated. If any of the support activities are outsourced, it has been decided to shift the released personnel slots of the outsourced department(s) to the city's waste collection and disposal service, the service that is experiencing the highest increase in demand.

The relevant operating and cost data are presented in Figure 2. Panel I lists each department's annual flexible, committed and total cost. A department's flexible and committed cost can be traced to each department. Flexible costs are those the department is expected to acquire as needed during the period while committed costs are the costs of resources the city has contracted to acquire over the

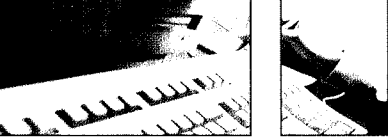
long term. Flexible cost can be determined by an examination of a department's expected level of activity while committed cost can be determined from a review of its contractual obligations such as equipment and building leases, insurance policies and employee benefit agreements. The time frame used for classifying the cost of resources as flexible and committed in the short run is one year.

In Panel II of Figure 2, each service activity and the general administrative department is listed. Below each department's title is its cost driver. The cost driver is used to trace the cost of an activity's services to cost objects that used its services. While the data processing department provides services to other departments within the city, it also receives services from the other support departments. Therefore, the cost of data processing is the cost of resources used within the department as well as the cost of the services it consumes from other service departments. The cost of the city's other service departments is a function of the cost of resources used within the activity as well as a function of the cost of the services they consume from the city's other service and general and administrative departments.

These reciprocal service relationships among the city's service departments are modeled with the cost equations in Panel I of Figure 3. These cost equations were developed from the flexible cost and resource usage listed in Panels I and II of Figure 2. For example, in Panel II of Figure 2, data processing used 10,000 CPU minutes of its own total service of 118,000 CPU minutes. Therefore, data processing should be charged 10,000/118,000 of its own cost for self-service.

The cost equation for each service department in Panel I has been simplified and rewritten in Panel II of Figure 3. The variables representing each department's cost appear to the left of the equal sign and the flexible cost of resources used within the department appears to the right of the equal sign. Each successive equation represents the cost of operating the data processing, HRM, accounting, legal and general administrative departments, respectively. A discussion of how the cost equations listed in Panel II were solved is provided in Appendix A.





The solution to the cost equations listed in Panel II and solved in Appendix A is listed in Panel III of *Figure 3*. As indicated in *Figure 3*, the flexible cost of the data processing department is \$275,510. This is comprised of \$190,000 of resources used in data processing, see *Figure 2* Panel I, and \$85,510 (\$275,510 - \$190,000) for the services of the HRM, accounting, legal and general administration departments consumed by data processing in producing its services. The flexible cost of the other departments listed in Panel III of *Figure 3* is comprised of the cost incurred within the department as well as the cost of the services it used from the city's other service departments.

The cost equations in Panels I and II were solved a second time using total cost for each service and general administrative department. The solution to the set of cost equations based on total cost is listed in Panel III of *Figure 3* under the column labeled total cost. The two sets of costs in Panel III represent the incremental and total cost of providing the services to each of Mountain Brook's service and general administrative departments.

## Analyzing the Costs of Each Department

The cost of each service department under operational ABC is presented in Panel I of *Figure 4*. As indicated the flexible cost in Panel I and total cost listed in Panel I and II of *Figure 4*, respectively, are the cost determined from the solution to the cost equations in *Figure 3*. The opportunity cost of providing service to each department is the benefit of the best alternative that was foregone due to limited resources. An analysis of Panel II of *Figure 2* indicates that all of the service departments, except for general administrative, have unused capacity. The cost driver for the general administrative department is the number of employees. Therefore, the number of employees is the critical resource that prevents the city from providing further services. If the city had additional employees, they would be used to increase the capacity of its waste department. Currently the city is unable to meet its sanitation needs at a satisfactory level. The county in which the city resides is providing assistance with this

**Figure 4: City of Mountain Brook Short- and Long-Run Cost and External Purchase Price**

	DP	HRM	Accounting	Legal
<b>Panel I: Operational ABC:</b>				
Flexible Cost	\$275,510	\$262,641	\$300,886	\$254,347
Opportunity Cost	187,200	93,600	374,400	93,600
Total Cost	<u>\$462,710</u>	<u>\$356,241</u>	<u>\$675,286</u>	<u>\$347,947</u>
Practical Capacity	120,000	2,500	240,000	1,800
Short-Run Unit Cost	\$3.86	\$142.50	\$2.81	\$193.30
<b>Panel II: Traditional ABC:</b>				
Total Cost	<u>\$578,253</u>	<u>\$584,349</u>	<u>\$585,159</u>	<u>\$535,516</u>
Practical Capacity	120,000	2,500	240,000	1,800
Long-Run Unit Cost	\$4.82	\$233.74	\$2.44	\$297.51
<b>Panel III: Cost Comparisons</b>				
Short-Run Unit Cost	\$3.86	\$142.50	\$2.81	\$193.30
Long-Run Unit Cost	\$4.82	\$233.74	\$2.44	\$297.51
Vendor Unit Price	\$3.25	\$200.00	\$2.60	\$325.00

service, but has indicated that it cannot perform the function over an extended time period.

Each additional employee assigned to the city's waste department would increase its capacity by 1,040 tons per year. Currently, the city is paying the county \$38 a ton for collecting and processing garbage. Of this amount, \$8 is for the nonemployee-related expenses. Therefore, the opportunity cost of outsourcing a department is the revenue that could be earned from released employee positions that could be reassigned to the waste collection and disposal service. In Panel I of *Figure 4*, the opportunity cost of each department is computed by multiplying its number of employee positions by the 1,040 tons of increased collection and processing capacity of a new employee times the net revenue of \$30 per ton of processed garbage. For example, the opportunity cost of the data processing department is \$187,200, or six employee positions\* 1,040 tons of processed garbage per employee a year \* \$30 cost savings per ton of processed garbage. The opportunity cost of the other departments listed in Panel I of *Figure 4* was computed in a similar manner.

The flexible and opportunity cost of each department is added to get its total short-run operating cost. This cost

is then divided by an activity's practical capacity to determine its short-run unit cost. For example, the short-run cost of data processing is divided by its practical capacity of 120,000 CPU minutes to derive a cost driver rate of \$3.86 per CPU minute. This rate is the short-run cost of internally providing a unit of data processing service. In Panel II of *Figure 4*, activity-based cost for each department is computed. This is the total cost from Panel III of *Figure 3* divided by the department's practical capacity.

The unit costs computed using the operational and traditional ABC models are listed in *Figure 4*, Panel III, in the rows labeled short-run unit cost and long-run unit cost, respectively. Also, the last row of Panel III lists the lowest outside vendor price for a department's service consistent with the quality and reliability of the city of Mountain Brook's current service departments.

## Analysis of Support Functions

An examination of the relationship between the short- and long-run service cost of the support departments and outside vendor prices (see Panel III of *Figure 4*) indicates that each department reflects one of the four possible outsourcing cases presented in *Figure 1*.

**Case One:** For the data processing function, the city of Mountain Brook can purchase the service from an outside vendor for \$3.25 per CPU minute. This price is less than the short- and long-term internal cost of \$3.86 and \$4.82, respectively. A review of *Figure 1* indicates that data processing's purchase price and costs represent an example of Case One. Accordingly, the data processing function should be outsourced over the short as well as the long term.

The need to outsource a support function in the short run frequently arises from the opportunity cost of using limited resources. As shown in Panel I of *Figure 4*, data processing's opportunity cost causes its short-run cost to exceed the outside vendor's price. Therefore, data processing is not economical to produce in the short run because the limited resources used in data processing can be used more effectively elsewhere in the entity's operation—for example, the Department of Waste Management.

The need to outsource a service department in the long run reflects the efficiency of the government in providing the service relative to the efficiency of an outside vendor. As indicated in Panel III of *Figure 4*, the cost of the resources used by the city of Mountain Brook to internally provide the data processing function is greater than the vendor's price. Assuming the vendor is not providing the service at a loss, the city is not as efficient as the vendor in providing the data processing service. Consequently, it is not economical for the city to provide the data processing function internally over any time horizon, and the city should consider outsourcing the function immediately.

**Case Two:** In Panel III of *Figure 4* the outside purchase price for each contact hour of personnel services currently provided by the human resource management department is \$200 per contact hour. This is greater than the city's short-term cost of \$142.50 per hour but less than its long-term cost of \$233.74 per hour. An examination of *Figure 1* indicates this is consistent with Case Two.

As indicated in *Figure 1*, the city should internally provide the human resource function in the short run but plan to outsource it at a later date. For Case Two to occur, a support function's long-term cost must be greater than its

short-term cost. A department's short-run cost is its flexible and opportunity cost per unit of service while its long-run cost is its flexible and committed cost per unit of service. Therefore, for a department's long-run cost to exceed its short-run cost, the committed cost per unit of service must be greater than the opportunity cost per unit of service. The committed cost in HRM's long-run cost is \$128.68 per contact hour. The cost is calculated by subtracting HRM's short-run flexible costs (\$262,641) from the long-run cost (\$584,349) and dividing by HRM's practical capacity of 2,500 contact hours.

HRM's opportunity cost is \$37.44 per contact hour, ( $\$93,600 / 2,500$  hours). Consequently, the need to internally provide HRM services in the short run is the result of using committed resources to provide HRM services. However, as the city's management is able to gain discretionary power over the committed resources, the resources become a flexible cost. In effect, over the long run, HRM's committed cost becomes an incremental cost of providing the service. Since the outside vendor's price is less than HRM's long-run incremental cost, it is not economical for Mountain Brook to provide the service internally over the long term.

An important aspect of implementing outsourcing in Case Two is to determine the time frame over which the support function should be provided internally. Failure to identify the point at which the city should stop producing the service and begin purchasing it from an outside vendor is critical for preventing a series of successive short-term decisions leading to producing the service over an extended time period. The time horizon for internally providing the service in Case Two is determined by how quickly the city's management can gain control over committed resources, making them equal to the difference between a department's short-term cost and an external vendor's price.

**Case Three:** In the case of the accounting function, it can be seen in Panel III of *Figure 4* that the outside purchase price per transaction is less than the department's short-run cost, but greater than its long-term cost. This relationship is consistent with Case Three presented in *Figure 1*. As indicated in *Figure 1*, the

city should outsource the accounting function in the short run but provide it internally at a later date for the long term. For the economic condition of Case Three to occur, a support department's short-term cost must exceed its long-term cost. As noted in Case Two, the difference between a department's short- and long-run costs reflects the difference between its opportunity cost and committed cost. When a department's short-run cost exceeds its long-term cost, a function's opportunity cost must exceed the cost of the committed resources used in providing the function.

A review of the accounting function in Panels I and II of *Figure 4* indicates that its opportunity cost of \$1.56 per transaction (opportunity cost of \$374,400 divided by accounting's practical capacity of 240,000 transactions) exceeds its committed cost of \$1.18 per transaction, which is derived by subtracting from the department's total cost of \$585,159 its short-run flexible costs of \$300,886 and dividing by its practical capacity of 240,000 transactions. The opportunity cost of internally providing the accounting function causes its short-run service cost to exceed its long-term cost as well as the outside vendor's price. Therefore, the need to outsource a support function in Case Three arises from the department's opportunity cost of using limited resources in a less than optimal manner. In effect, the accounting function should be outsourced in the short run because the resources used in its production can be used more effectively elsewhere in the government entity's current operations. However, as the city is able to reduce the opportunity cost of internally providing accounting services, its cost will fall below the outside vendor's price and become economical to provide.

In Case Three, it is not economical to provide the accounting function internally in the short term, but economical to provide it over the long term. Therefore, the city must carefully evaluate whether to outsource accounting. If it decides to outsource the function, then the city must determine the time frame over which to purchase the service from an outside vendor. Failure to determine the time period to purchase accounting services externally can lead to a series of short-run decisions resulting in purchasing accounting service over the long term.



A support department's opportunity cost can be reduced by reducing the resources required to provide a unit of service or by increasing the capacity of constrained activities. Either action will reduce a support department's opportunity cost and make it more economical to provide the service. For example, the city of Mountain Brook should determine the time frame required to reduce the number of employees required to perform the accounting function or when the hiring freeze will be lifted and more employees can be hired. The length of time required to perform either action determines how long the accounting function should be purchased externally and the point at which the city should begin to internally provide the service.

**Case Four:** It can be seen in Panel III of *Figure 4* that the legal department's market price per consultation hour is greater than its internally provided short- and long-run cost. As indicated in *Figure 1*, the economic attributes of the legal department are consistent with Case Four. A review of *Figure 1* suggests that the legal function should be maintained in the short as well as the long run. This result indicates that the city has a competitive advantage in providing the legal services because it is operated more efficiently than an external vendor that specializes in the support service. In fact, the city of Mountain Brook should consider selling some of the legal services to nearby government organizations.

## Avoiding Contradictory Decisions

The importance of integrating information from the traditional ABC and operational ABC models to evaluate outsourcing non-core service functions is illustrated in Cases Two and Three in *Figure 1*. Evaluating the economics of outsourcing with either the traditional ABC or operational ABC models leads to identical decisions in Cases One and Four in *Figure 1*. However, in Cases Two and Three, using either model alone will lead to contradictory decisions. For example, if the operational ABC model were used to evaluate Case Two, the city of Mountain Brook would keep the HRM department in the short term and make a series of short-term decisions that could lead to providing the function over

an extended time period. Conversely, using the traditional ABC alone in Case Two would lead to outsourcing HRM immediately, even though it is more economical for the city to continue internally providing the support service in the short run. In Case Three, using the operational ABC alone would lead to outsourcing the accounting department immediately without considering the need to provide it internally in the future. Conversely, using the traditional ABC would result in maintaining the accounting department in the short run and result in suboptimal use of its resources.

## Conclusion

The objective of public sector outsourcing is to move the government entity toward a more optimal use of its limited resources and, thereby, improve its effectiveness. To maximize the benefits of outsourcing while minimizing its potential risk of incorrect decisions, government administrators must understand that outsourcing to restructure a government's operations can have short- as well as longer-term benefits to the organization. Outsourcing based on short-term cost reductions and cash flow considerations can lead to unintended and adverse consequences. Consequently, government administrators, in their outsourcing decision-making, must use economic data that reflect the short- and long-run costs of internally provided support services, and consider related resource constraints. Failure to consider such information can lead to suboptimal outsourcing decisions.

The operational ABC and traditional ABC models may be used to measure a service department's short- and long-run operating costs and any associated opportunity costs. The information developed from the operational ABC and traditional ABC models may be combined to identify which of the four cases of outsourcing is presented. Such information will assist administrators in determining if outsourcing a department or program is economically feasible, the time period over which it's feasible, and why it's economically feasible. Public sector administrators are then in a better position for making more informed outsourcing decisions. ¶

## End Notes

1. N. Bakke and R. Hellberg, "Relevance Lost? A Critical Discussion of Different Cost Accounting Principles in Connection with Decision Making for Both Short and Long Term Production Scheduling," *International Journal of Production Economics*, Volume 24, 1991, pp. 1-18.
2. R. Kaplan and A. Atkinson, *Advanced Management Accounting*, Third Edition, 1998.



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