



**PUBLIC SECTOR MARKET TESTING \**  
**FOR CONTRACTING OUT:**  
**SOME IMPLICATIONS FOR**  
**ACCOUNTING AND MANAGEMENT.**

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## Abstract

One objective of government is to provide services at least cost, whilst maintaining or improving service quality. This may be the main goal, but questions are now being asked whether the service ought to be provided directly by the government or by the private sector. The shift of services from the public to the private sector is known by several terms such as market testing, outsourcing or **competitive tendering and contracting out** (CTC). The objective of this study is to investigate if and how accounting information is used by public sector managers in a major Commonwealth (Australia) Government Department to decide whether a service should be contracted out. The contracting out of Corporate Services with special reference to legal services is used as an exploratory case study to identify the variables associated with management decision-making in the contracting-out process.

An **avoidable-cost approach** was used to determine the level of estimated savings from contracting out and these were verified by external accountants. There were differences of opinion among management staff as to the reason for contracting out legal services. Some believed it was dollar driven; others were of the opinion that quality was the underlying reason, whilst a third theme suggested that ideology and political motivation was the driving force. This suggests the need for better documentation and embedding of process. Nevertheless, the **accounting system** did drive, in part, the decision to investigate the possibility of **contracting out** corporate services.



## **Introduction**

CTC is not a new strategy used by government agencies. In the past, typical services that have been subjected to contracting out include security, cleaning, catering and property maintenance. The focus of attention has been extended to ‘white-collar’ activities such as Corporate Services. Corporate Services can include activities such as Payroll, Human Resource Management, Audit Services and various finance functions termed Business Services. At the Australian Commonwealth level, the Department of Finance and Administration (DOFA) through the Office of Asset Sales and Commercial Support (OASACS) is guiding the Market Testing and Contracting Out (MTACO) initiative. According to DOFA’s website:

*The OASACS is providing assistance to agencies to enable them to market test relevant activities (other than IT). The Corporate Services functions have initially been selected for market testing.*

No detail is provided as to why Corporate Services was chosen for MTACO, but discussions with various personnel conducted during our interviewing phase indicated that this is an area where contracting out may enhance the level of expertise in the respective agency. In addition, it was a Cabinet decision to market test all Corporate Services, and thus, agencies were following a Cabinet directive.

The case of the MTACO of legal services in this Commonwealth Government Department is unique because the model adopted was not the traditional ‘Purchaser (government)-Provider (private sector contractor)’ version. Instead, the private sector contractor led the legal services branch where the staffs were continuing public sector employees. That is, the private sector contractor had one of its own employees as, effectively, the branch head of a government service unit.

## **Literature review**

MTACO falls under the ambit of privatisation and this strategy has been the subject of much heated debate (Osborne and Gaebler, 1992). This is due in part to a lack of consensus as to whether privatisation cures the difficulties an organisation may be facing, confusion of who are the ‘winners’ and the ‘losers’ and also because of the irreversibility of such a strategy. Cases of privatisation ‘failure’ are numerous (Letza and Smallman, 2001; Crompton and Jupe, 2003; Hodge, 1997) and demonstrate that it is not a panacea for government failures.



MTACO has the potential not only to change the way government services are delivered and the ultimate structure of government itself, but also to affect the nature, extent and importance of accounting information for informed decision-making. There are important cultural changes that occur in privatised organisations and it is not uncommon for a new accounting system to be adopted (Gowland & Aiken 2003). An ‘accounting language’ develops which facilitates communication between the relevant actors in the organisation. Commonly quoted terms such as ‘preference for market mechanisms’, ‘business-like management practices’, ‘empowering consumers’ and ‘New Public Management’ (NPM) are now elements of ‘accounting-speak’ in many public sector organisations (Hood 1995). There appears to be a need to explore the consequences of these accounting and management reforms (Potter 2002).

MTACO is a challenge for many government agencies, and the traditional roles of the government finance officer and senior manager have the potential to change and evolve significantly. Its rationale has been sold to the general public on the premise that the private sector is more efficient than the public sector (Donald and Hutton 1998), although there is evidence which disputes this assertion (Davidson 2003; Martin and Parker 1995, p.225). Other potential advantages include access to expertise, greater flexibility in service provision, increased quality of service and greater certainty of outcomes. However, there are also risks in using MTACO as a vehicle for service provision. Funnell (2003) identifies the potential for agencies to shirk their responsibility and accountability for service outcomes on the basis that they no longer provide the service directly. Some of the areas which require attention include:

1. Problems with access to information (in particular for auditors-general) regarding the contracts due to clauses such as commercial-in-confidence;
2. “Cherry picking” by private sector providers in choosing only the lucrative services and thereby leaving the government with the high cost services, and
3. The risks for public sector managers who have varying degrees of expertise in contracting.

Cost information is not a generic, value-free, commodity. It is established to meet the specific needs of the organisation and its quality not only depends on the technical accuracy of accounting numbers, but also on the use of professional and informed judgement. Research in to whether, and how, management accounting information is used in a government setting is underdeveloped (Lapsley 2000). This project provides useful insights as to why and how



public sector managers use accounting data to legitimize a decision to outsource legal services.

Traditional reasons for the lack of any sophisticated accrual accounting systems and, in particular, cost information within government agencies tend to be related to the absence of the profit motive (Guthrie 1998). Further, the inadequacy of the cash-based system which was traditionally aligned with the government's budget and appropriations mechanisms has meant that cost information, for budget sector agencies, has, in the past, been an 'optional extra'. The move to MTACO means that the accounting information system must now not only provide information that funds have been spent, but also that they have been spent economically and effectively.

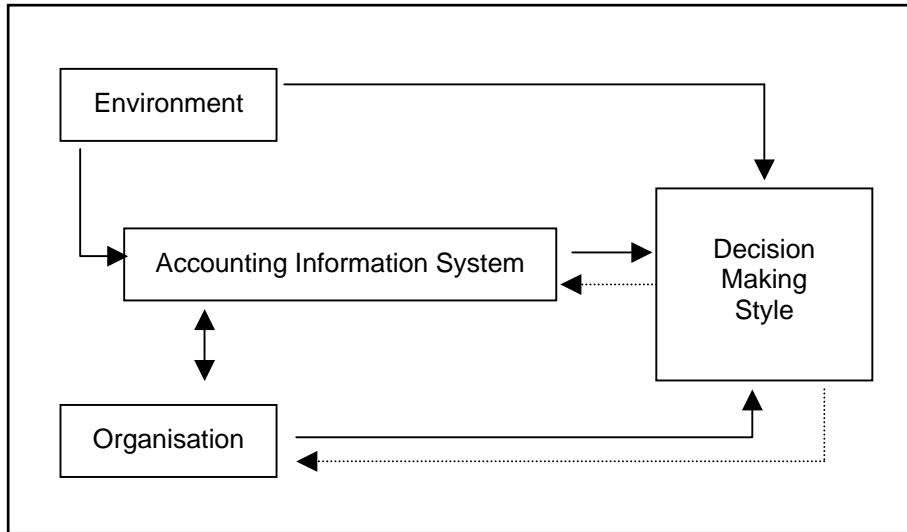
### **Motivation for Management Accounting**

Management accounting is sometimes used synonymously with cost accounting to mean that information which is designed or adapted for the particular needs of an organisation. Geiger (1995) separates costing into financial costing to mean cost information for external reporting, regulatory cost accounting referring to cost information to be reported to some outside authority, and managerial cost accounting to serve the cost information needs of managers.

The seminal work of Gordon and Miller (1976) can be used as a theoretical framework to help explain the development of accounting information systems. Figure 1 illustrates the elements of their contingency-theory-based model. All three elements, that is, the environment, the organisation and the style of management can affect the development of cost accounting systems. The environment in this case would be MTACO, and interviews with key personnel in government departments would provide an indication of the main influences. For example, Geiger and Ittner (1996), in their investigation of five American Federal Government Departments, found that the requirement to generate revenue (user-pays), not government-imposed cost accounting requirements, was the major motivational factor for the increased use and sophistication of cost accounting systems. This suggests that current accounting systems used by government departments may not generate useful reports for management decision-making when there are significant government policy changes.



**Figure 1 The Accounting Contingency Framework**



*Source: Gordon, L.A. and Miller D.A., (1976, p. 59)*

Therefore, conformity with mandated accounting guidelines takes place because there are costs associated with non-compliance such as critical remarks by the auditor.

Geiger (1993) in his investigation of the Examinations Division of the Internal Revenue Service (IRS) found that the introduction of a cost accounting system led to an increased awareness by managers of the types and magnitudes of certain costs. In the first instance, agencies need to be able to identify cost items to determine which, if any, can be reduced. Agencies, in general, are able to report funds expended via budget reports but do not have the capacity to report the true cost of programs, mainly because their accounting information systems have not been set up to record and report this information (Gianakis 2002, p.48).

Using MTACO simply as a short-term cost-reduction mechanism may lead to unintended consequences. MTACO used within an overall strategic context means that the accounting system must not only provide cost comparisons between alternative providers, but do so in the framework established by policy makers.

Transaction cost economics (TCE) is an alternative paradigm that has been used to explain and support the use of contracting out (Langfield-Smith & Smith 2003). Covalleski et al (2003) emphasize the risk of opportunism where there is significant asset specificity. The collapse of Enron Corporation is used to demonstrate how opportunistic behaviour by the



‘new players’ in the energy market cancelled out any efficiency benefits that were claimed by the State of California.

A lack of financial management training of program managers can lead to scepticism when confronted with elaborate and sometimes convoluted cost terms and techniques (Hairston 1985). This issue has been highlighted in the work by Purdy and Gago (2002) where six of the seven public sector managers interviewed regarding their use of accounting information were deemed to be naïve about the handling of the data received. Further, managers may dispute the arbitrary cost allocations made, especially with respect to support service costs and denounce the process as ex-ante decision-making. Finally, program managers may feel threatened by the new role and power which accountants will have in order to justify contracting-out decisions. In other words, accountants or finance officers in the public sector had in the past an almost sedentary role of ensuring that expenditures and revenues approximated to the budget and produced reports to managers highlighting variances. Rarely did they question the type and/or service delivery method, or were they required to provide information which would lead to the decision that an outside private sector provider ought to deliver the service on cost and/or quality grounds.

The power to furnish information in the context of market-testing is unprecedented for many accountants working in the public sector (Broadbent 1999). It can lead to higher risks, in that with the emphasis on the devolution of responsibility, managers will have to rely upon the information collated by accountants and others to justify their decisions. This suggests an even greater reliance on the accounting system not only to provide information because of mandated financial reporting requirements, but also to be an integral part when evaluating alternative decisions and service providers.

Although the contracting out of services within government agencies is not new, the policy, zeal and implementation of its procedural requirements suggest that commensurate resources will be needed to develop or up-date the current accounting information system.



## **Methodology**

Since the Cabinet decision to embrace MTACO also requires that an audit review of all contracted-out services be undertaken, it was decided to make E-mail contact with the Australian National Audit Office (ANAO). It was assumed that the ANAO would have a database of agencies currently engaged in a market-testing exercise. Of the four possible contacts provided by a representative of the ANAO, one Commonwealth agency accepted our invitation to participate in this research project.

Interviews were established so that a full day of interviewing could be conducted with the key players in this contracting-out exercise. The interviews were semi-structured and were tape-recorded. Semi-structured interviews were selected to prevent the interviewees being constrained as to the type and extent of information they had and could provide. This permitted the interviewees to:

- discuss how they were involved in the MTACO exercise;
- elaborate on what they learned personally from the experience and what organisational learning occurred; and
- provide detailed insights into the motivation, challenges and (if any) their resolutions in undertaking the contracting out of corporate services, in particular, legal services.

Four in-depth interviews were conducted. The duration of each interview was between 1.5 and 2 hours each. Each interview was tape-recorded. Concern was expressed regarding the privacy of individuals and the perusal of documents produced by this department. In light of this, confidentiality agreements were signed and assurances were given that no individual names would be used as part of this research report. It was anticipated that these protocols would provide a forum where interviewees could express their views freely.

## **Data analysis**

The interviews were transcribed, and a process of theme development also known as pattern-matching was undertaken to identify major subject matters originating from the interviews (Lowe 2001; Llewellyn, 1999). Because this is primarily an intuitive process, a co-researcher independently undertook the same task and, in the main, identical themes were detected. This course of action improves the validity of the findings (Miles and Huberman 1994).





## **Findings**

### **Origin of MTACO**

The implementation of MTACO is a case of a management ‘top-down’ approach. As it was a Cabinet decision to market test Corporate Services in each of the Commonwealth Government Departments there was strong support for MTACO by senior management of this agency. A senior manager commented that:

*Market testing is such a valuable tool that it actually in my view gets people to think in terms of what we want to do here now. I seriously believe that this is a very educative process and it's about knowledge of business practice.*

This view is supported in the relevant literature in that MTACO is a philosophical position, that is, it perceives the private sector to be superior, on both cost and quality grounds, to the public sector. This is implied in the MTACO guidelines given that in-house bidding is not permitted. The support of senior management in the MTACO of the legal services was also an important factor after the decision had been made to select an external private sector provider.

A Senior Legal Manager commented:

*The other thing that has been good for me is that it has been a very flexible arrangement, enormous understanding and goodwill on both sides....very strong commitments on both sides to make it work....key people of the department wanted to make it work and that was very critical.*

Again, this evidence lends support to the view that the success or otherwise of MTACO is dependent on, amongst other things, a commitment to develop a business relationship with the external provider beyond the written clauses in the original contract.

### **Accounting information system**

Before any use was made of the accounting information system, the department went through a survey process to determine the length of time staff spent on each activity. Breaking down the job function into individual activities has two major benefits. First, it allows for an identification of how time is spent/allocated, and second, it allows for better management and improvement of the efficiency of performing the activity. As quoted by the Assistant Secretary:

*For me in-house bids gets in marginally into that territory, where people get focussed on the cost of delivering services the way they deliver them, and it is a very good thing to sharpen peoples' minds and go through the process of bidding purely because of the rigour.*

A typical issue that arose was that staff at the operational level did not relate certain costs to their activity because the costs were paid centrally by the agency. Examples of the type of costs, which staff believed were ‘free’ included telephone, stationery, internet and rent. There was further criticism of the accounting information system not being able to adapt to the



strategy of contracting out and a degree of scepticism regarding whether accountants are able to overcome these inadequacies.

As explained by a Senior Manager:

*There are costing methodologies that are applied to give a baseline cost. If you talk to accounting people they will convince you that they are using a tool that is quite solid and can adequately factor in all the relevant costs associated with delivering that function.*

Moreover, by having this cost data available the buyer of the services (in this case, the government agency) has superior knowledge and an improved bargaining position. The buyer can question the potential provider on costing issues, thereby improving the understanding between the parties and may also provide the opportunity to mitigate some costs.

Although Commonwealth government departments can and do now report on an accrual accounting basis, the move to MTACO represents a major shift in how accounting information is utilised. A senior financial consultant working within the government department stated that:

*The comment I make is pretty generic across government, where they have gone through very expensive finance systems, an expensive implementation process with multi-million dollar SAP systems; the problem is they do not think about the reporting side of things, they do not consider the information, they are more concerned about the inputs.*

What appeared to be occurring is the wholesale adoption of a new computerised accounting package (SAP) without any adjustments made to enhance the reporting function. That is, the old chart of accounts was inserted in the sophisticated SAP Package, but this did not improve management reporting.

In any case, the information required for MTACO decision-making cannot be taken directly from accrual-based management reports. Each MTACO business case will be different, and requires managers to make estimates and assumptions as to which costs would be avoidable (and therefore saved by the agency) if the service is contracted out. As explained by a Senior Manager:

*We were very careful to pick through the accounting system and identify those (avoidable costs) as well as we possibly could. That is where the accounting system is handy. It does not tell you what is avoidable and what is not avoidable, you literally have to pick through the ledgers and write down the decisions; if I close this down, that one goes, but that one does not. The accounting system does not do it automatically for you.*

This is an area of the MTACO strategy that requires further investigation. Given that these avoidable costs are estimates of the money that will be saved by the government agency, careful monitoring of these costs is required to ensure that the predicted savings are realised. This is an important matter because if these costs do not become avoidable during the



employment of the private sector contractor, then, the predicted savings will not eventuate. This issue takes on increasing significance if reducing costs was a reason for undertaking MTACO in the first instance.

### **Comparing Apples to Apples**

When making a costing comparison between a government provided service and private sector bidders, it is appropriate that the financial comparison is made ensuring that exactly the same services are costed. A major component of this comparison is known as competitive neutrality. That is, the baseline government cost is adjusted to include items that could put the private sector at a disadvantage. For example, where the private sector has to pay for various taxes and the government agency does not, then, the costing template of the government agency would be adjusted to include these notional taxes.

In addition a profit margin (also described as the cost of capital) is added to the baseline cost of the government agency, because it is assumed that private sector bidders will also include a margin within their total price. This is done to ensure that no party is put at a comparative disadvantage. The issue though is that there could be a whole array of costs that either the government agency or private sector contractor either includes or excludes from their costings, but this information is usually not disclosed to either party. As suggested by a Senior Manager:

*You can see what I am getting at; as much as you try you cannot do like-for-like in the classical sense. Mainly because this guy (the proposed contractor) will not tell you any of his business, however I did ask, he just laughed. What did I expect?*

Normally, only the final tender price is provided for assessment by the government agency as part of their selection criteria, but there is no legal impediment why private sector contractors cannot provide further disclosure of what made up the final tender price. For legal services, it was not difficult to factor in competitive neutrality items except for superannuation where the Commonwealth government can pay anything between 15% and 22% whereas the private sector has an obligation only to pay 9%.

Another limitation in making comparisons is that they are made between the cost of the current service provided internally against the cost of external provision. The issue here is a normative one. That is, should the comparison be made between a restructured/re-engineered government internal service provider and the preferred external contractor, or, between the



current level and quality of service provided and the preferred external contractor. The implications of this dilemma have consequences not only for the need to improve the assessment of the benefits of MTACO but, more importantly, for the potential effect it could have on overall government policy.

The most likely outcome would be that if the re-engineered internal service provider is compared with external providers, then the level of savings (if any) from MTACO would be less than if the comparison was made between the current service and external providers. The reason being that, with a re-engineered service, identification and removal of inefficiencies could be made so that a more realistic, and thus, competitive bid is submitted. According to the financial consultant interviewed, there appear to be problems associated with being accountable for a re-engineered service (future-based pricing), hence:

*(Private Industry) are sitting there and saying alright we are going to put a bid in and whatever price we come up with we are going to be accountable for that, and if we under-quoted the work, then, we are going to have to live with it. Whereas, an in-house manager may say we can do it with a couple of staff, and then down the track all of a sudden it starts to fall out a bit. You do not have the same comeback in that respect.*

More to the point, it appears that a standard for CTC is required so that management is aware of the basis of the expected savings. Disclosure of whether the changes in costs are based on the current or re-engineered service cost is necessary for informed assessments regarding the benefits of CTC.

The accounting for redundancy costs was a controversial item. For example, the experience from the Department of Defence, where the total cost of redundancies is amortised over a ten-year period, meant that most of the in-house bids won the tenders. Rather than take this generic approach to redundancy, in the agency that was investigated for this research, each service was looked at on a case-by-case approach because some staff could be re-deployed in other public sector jobs, or temporary/casual workers were made redundant, hence avoiding a redundancy cost. In cases where permanent staff would be made redundant, the redundancy cost was amortised over the period of the contract.

### **Loss-leading behaviour**

Loss-leading is the term used where bidders put in an unrealistically low price for a contract with the aim of winning the tender. Once established in the business, they offer additional services at a higher than market price. Or because they have gained corporate knowledge are



thus in a preferred position to win future tenders even if their price is deemed excessive. As suggested by one consultant:

*If anything it (loss-leading) happens with legals.....they have taken loss-lead to the extreme. They come in with very cheap pricing for the base work and once they get in the door, it is, we can give you this and we can give you that, while they are actually in the original contract.*

To minimise loss-leading occurring the agency evaluated the price and technical merit (quality) to reduce the number of bidders. Then, a process of sensitivity analysis was undertaken to observe under different scenarios which bidder would provide more value for money. The question of mitigating loss-leading behaviour by utilising a fixed contract was canvassed. This was deemed to be inappropriate as all of the risks are transferred to the provider thereby compelling the private sector provider to increase its price to prohibitive levels. Merritt (2004, p.55) also noted that contracting out is in effect the transfer of entrepreneurial risk to the corporate sector and public risk in the government sector to professionals.

### **Loss of Corporate Knowledge**

There was concern expressed that selecting a private sector provider would result in a loss of corporate knowledge. That is, the agency staff would be made redundant and take with them all the corporate knowledge gained over many years. Also, there would be no re-generation of corporate knowledge within the agency. Whilst there may be some validity attached to this concern, the counter claim put forward by management was that innovative ways of thinking and doing things can only be accomplished by engaging in a major overhaul of staff and processes. This was evident in the case of legal services.

As explained by a Legal Service Manager:

*This is how you can bring some private sector thinking (to emphasize the customer focus) into a public sector context for managing and running a legal service branch and I think we have done that. I cannot give you what you need from the academic's point of view, very hard data to prove that this has happened, but I like to believe that it has been good.*

The lack of hard data and reporting refer to the issue that time sheets are not used in the public sector whereas in the private sector they are used as standard practice to gauge the level of activity and for billing purposes.

The private sector contractor believed they were very much a part of the government unit and were focussed on meeting client needs and that the legal expertise required was not there (in-house) in the first instance. In fact, during the term of this contract, a number of public sector employees undertook secondments with the contractor. It was acknowledged by the



contractor that regardless of how competently the job was undertaken, there would be some staff that would take issue about the private sector in there, dealing directly with the Minister, dealing with Cabinet in confidence, dealing with budget in confidence.

### **Conclusions and Implications for Managers and Policy Makers:**

Whether or not an agency decides to implement a MTACO strategy, there appear to be numerous advantages and disadvantages that require careful consideration. From the evidence obtained in this research project, it is apparent that the process of MTACO compels managers and other staff to identify the services/activities they are providing and to question whether in-house provision is the best and most efficient method of providing the service. At the most basic level questions could be asked if the activity needs to be undertaken at all. This re-assessment provides the opportunity for creative thinking and allows for an evaluation of what level and nature of service the 'market' is currently providing. That is, MTACO provided an opportunity for a benchmarking exercise to be completed, and staff to become aware that they are competing with the wider private sector for their positions.

Another benefit is in relation to the identification of costs. Although the costing methodology utilises imperfect information, estimates and professional judgement, especially where indirect costs are the subject of investigation, it nevertheless draws attention to the fact that there are no 'free' products or services. Management must be careful in selecting MTACO if the objective is to reduce costs of service delivery. This is because several of the baseline costs at best can only be estimates. Generalisations regarding the efficacy of MTACO are problematic, and each service must be evaluated on a case-by-case approach.

Successful contracting out with respect to improvements to service quality and/or reductions in costs is dependent on several factors. For example, the availability and accuracy of current information of the service in terms of costs and performance standards, the implementation of the MTACO strategy and the on-going management of the contract. The evidence in this investigation supports the literature where trust and goodwill between the purchaser (government) and provider (the private sector contractor) is pivotal in developing and nurturing the relationship. If this is an important consideration for government, then, further research could focus on how a government purchaser is able to identify and measure trust and goodwill when assessing and selecting competing providers.



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