STATE OF OHIO
OFFICE OF THE AUDITOR

JIM PETRO, AUDITOR OF STATE

Auditing and Management

Governmental Financial Management for the Twenty-First Century

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EXECUTIVE SUMMARY

Public concern about receiving value for their money is not a new phenomenon; nor is government attention to this concern. What is new is that recent technological advances, particularly with respect to relatively inexpensive personal computing, has made it possible to assemble and analyze data in order to better determine how well public programs and activities are leading to the results intended by the legislative bodies that established them. In recent years new financial management systems have been developed which enable governments at all levels to assess how well their expenditures are meeting their goals and to re-engineer those operations that are not.

Increasingly, federal agencies, states and local governments are using these interdependent management processes to assist them in results-based management: (1) strategic planning, (2) performance measurement, (3) benchmarking, (4) managerial accounting, (5) accountability in budgeting, (6) service efforts and accomplishments reporting, and (7) performance auditing.

The General Assembly has become increasingly supportive of results-based management and the processes that lead to it. At the state level, during the FY 1996-1997 biennium they authorized the state Office of Budget and Management to conduct performance reviews of selected state programs and performance data for six major agencies was incorporated into the Executive Budget Document in the FY 1998-1999 biennium.

At the local level, the state legislature directed the State Auditor to conduct a performance audit of the Cleveland City School District and for the current biennium has directed similar audits for the 21 largest school districts. Performance audits may also be conducted for any school district that is in a state of fiscal watch or fiscal emergency. In addition, a state system of performance standards has been established for all school districts and a new office has was created in the state Department of Education to establish benchmarks for school district academic and operational performance.

The Office of the Auditor of State has begun to issue regular benchmarking ratio analyses for all units of local government to enable them to see how they compare with peer units and as indicators of where they are heading.

These are all strong indicators of the importance now being placed in Ohio on results-based management. This report is prepared to discuss new financial management processes which enable local government managers to consider how they might adopt these processes in their own operations.

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ABBREVIATIONS

ABC - Activity-Based Costing
AGA - Association of Government Accountants
ASPA - American Society for Public Administration
BPR - Business Process Reengineering
CFO - Chief Financial Officers' Act
EMS - Emergency Medical Services
FASAB - Federal Accounting Standards Advisory Board
GAO - General Accounting Office
GAP - Commission on Government Accountability to the People
GASB - Governmental Accounting Standards Board
GFOA - Government Finance Officers Association
GPEFR - General Purpose External Financial Reporting
GPRA - Government Performance and Results Act of 1993
MIS - Management Information System
OBM - Office of Budget and Management (Ohio Agency)
OMB - Office of Management and Budget (Federal Agency)
PAR - Program Authorization Reviews
SEA - Service Efforts and Accomplishments
TQM - Total Quality Management

BACKGROUND

"Financial managers and audit professionals, no longer content simply to be "money police," are becoming partners with program managers to enhance service to citizens."[1]

Public attention to accountability has increased significantly in recent years as a result of increased citizen concern that governmental monies are either spent unwisely or wasted. All levels of government are perceived as being unresponsive, gridlocked and overly bureaucratic. There are widespread reports of mistrust of government and its leaders to achieve intended results, whether those results are decreased crime, an educated populace or a healthy environment, to name just a few of the purposes of governmental policies and programs.

The federal government and state and local governments throughout the country have responded to negative citizen attitudes by developing and using new financial management tools to help to re-engineer operations. The passage of the federal Government Results and Performance Act of 1993 has advanced the movement towards managing for results. This has been the subject of resolutions by the Government Standards Accounting Board, the National Academy of Public Administration and the American Society for Public Administration — encouraging all governments to utilize performance measurement and reporting systems. The federal act sets out the classic procedure for results-based management. All federal agencies must adopt strategic plans with established performance goals; they must report to Congress on how well they have performed compared to their goals so that Congress can use this information in its appropriations process. States and local units of government are adopting similar management systems.

PURPOSE

The purpose of this paper is to (1) discuss emerging trends in governmental financial management, (2) highlight some of the current work of states and localities which have transformed their financial management systems, and (3) identify some of the difficulties attendant to implementing these new systems. The intent of the paper is to stimulate discussion among local government financial managers on ways in which Ohio can proceed toward adopting new budget and accounting systems which will enable governments to achieve good performance outcomes.

[1]William R. Phillips, Bonnie L. Brown, C.Morgan Kinghorn, Andrew C. West, *Public Dollars, Common Sense: New Roles for Financial Managers*, Coopers & Lybrand, Washington, D.C., 1997.

INTRODUCTION

With the widespread use of computers at all levels of government, it is now possible to measure and report accurately on the cost, value, and results of public services, assets and improvements. With this kind of information it is possible to predict future trends and provide government program managers with information to make cost-effective decisions. Federal, state and local governments have developed innovative ways of managing the public's resources in order to achieve the *results* intended by the legislative body when it established each governmental program. Financial management in the 21st century will see the widespread use of these processes:

- ***Strategic Planning***, by which government agencies establish their mission and performance goals.

- ***Performance Measurement***, whereby a government jurisdiction quantifies how efficiently and cost-effectively it has used its resources in delivering public services using a baseline (standard, norm or criterion) against which to assess performance in a program or services.

- ***Benchmarking***, which is used to identify, analyze, adopt and adapt the high performance processes of other organizations that excel at doing a particular activity.

- ***Managerial Accounting***, which consists of (1) accumulating and reporting costs of activities on a regular basis for management information purposes, (2) establishing responsibility segments to match costs with outputs, (3) determining full costs of government goods and services, (4) recognizing the costs of goods and services provided among [governmental] entities, and (5) using appropriate costing methodologies to accumulate and assign costs to outputs[2].

- ***Accountability in Budgeting,*** which means utilization of a budgeting system which allocates resources according to results and holds agencies responsible for budgetary outcomes.

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[2]*Managerial Cost Accounting Concepts and Standards for the Federal Government*, Statement of Recommended Accounting Standards #4, U.S. Office of Management and Budget. The word "government" was substituted for "federal" to suggest the more universal applicability of the statement to state and local governmental entities.

- ***Service Efforts and Accomplishments (SEA) Reporting***, recognizes that a critical component of performance measurement is to report on the status of goal achievement to decision makers and the public.

- ***Performance Auditing***, which is defined by the Association of Government Accountants as, "the systematic and objective assessment of the performance of an organization, program, function or activity by an independent auditor, who reports findings, conclusions, and recommendations to a party or group with legal responsibility to oversee and/or initiate corrective action".

All of these processes are interdependent and flow from one another. Strategic planning requires a clear statement of agency mission; the mission statement will determine what performance measures are appropriate. Benchmarks flow from the goals and objectives of an organization as established in its strategic plan. The mission statement establishes why the organization exists and the goals are the results that support the mission. Only a managerial accounting system, however, will provide the kind of accurate data needed to measure performance and a performance budgeting system permits the allocation of resources in such a way as to enable goal achievement. An SEA reporting system enables an organization to report to decision-makers and the public on how it is doing toward accomplishing its goals and performance auditing enables an outside entity to confirm the efficiency and effectiveness of the organization in achieving its goals.

STRATEGIC PLANNING

"Strategic plans are intended to be the starting point for each agency's performance measurement efforts. Each plan must include a comprehensive mission statement based on the agency's statutory requirements, a set of outcome-related strategic goals, and a description of how the agency intends to achieve these goals. The mission statement brings the agency into focus. It explains why the agency exists, tells what it does, and describes how it does it. The strategic goals that follow are an outgrowth of this clearly stated mission. The strategic goals explain the purposes of the agency's programs and the results they are intended to achieve."[3]

It is generally agreed that in order to implement principles of continuous change, results-oriented operations, business practices re-engineering and management improvement, an organizational entity must begin with a strategic plan. In the case of the federal government, the Government Performance and Results Act of 1993 (alternately known as GPRA or The Results Act) mandates all federal agencies to prepare and submit to Congress strategic plans as the first step towards

[3]United States General Accounting Office, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, GAO/GGD-96-118, June, 1996.

achieving results-driven governmental operations. A recent U. S. General Accounting Office (GAO) report examined the efforts of seven states in establishing results-oriented performance measures and recognized that all of these states had strategic planning systems in place. In states without a statewide process, individual agencies have established their own strategic plans. While the State of Ohio does not have a statewide process, individual agencies, including the Auditor of State's Office, have established their own strategic plans. The same is true for localities--some have jurisdiction-wide plans while in other cases individual agencies have established plans.

According to GAO's review of leading results-oriented organizations these three practices are critical in strategic planning. Organizations must (1) involve their stakeholders; (2) assess their internal and external environments; and (3) align their activities, core processes and resources to support mission-related outcomes. This can be accomplished by following the traditional model of strategic planning, which has been widely used in small and large organizations, both in business and in government. It begins with a vision; proceeds with the development of a mission statement; sets out long-term strategic goals and short-term objectives and plans and establishes a system of monitoring progress towards goals with periodic and routine renewal to adjust the plan to environmental changes.

Vision

A vision statement is a description of what is expected to be the outcome of the implementation of an organization's strategic plan. It is a view of where the organization wants to be at some point in the future. While usually expressed as broad statements, visions point the direction that an organization wants to go. Developing a vision statement typically involves top management setting out desired organizational results, assessing internal and external environmental barriers to achieving those results and formulating strategies for overcoming those barriers. The vision statement is used to test whether all actions later developed lead toward making the vision a reality.

The vision of Ohio's Auditor of State is:

> *The Office of Auditor of State, utilizing the services of a diverse, multi-disciplined, dynamic and well-educated staff, strives to be a national leader in the application of innovative ideas and technology. With a commitment to professionalism, both in quality and quantity of service, the Office of Auditor of State endeavors to provide value to clients while effectively achieving its goals. The achievement of these goals will result in improved client and internal confidence combined with the perception of value, fairness, integrity and consistency in the services that we provide.*

Mission Statement

A mission statement should clearly establish why an organization exists, what it does and how it does it. It should be concise; it should be consistent with the statutes, charters or other legal authority establishing it; it should reflect the needs of its customers and stakeholders; and it should be easily understood. The mission statement for Ohio's Auditor of State's office is:

> *The mission of the Office of Auditor of State is to promote and preserve the confidence of Ohioans in their state and local governments; to serve those governments by promoting standards of excellence in financial oversight and reporting, by providing training and recommending resources to those governments to make sound financial decisions, and by providing trusted, professional, non-partisan, independent review of government financial conditions and compliance with all applicable laws.*

Strategies, Goals and Objectives

In the traditional model a *strategy* is a written description of how an organization will move from its current state to a future state, described in terms of accomplishments; a *goal* is a three-five year specific, measurable milestone of the strategy; and an *objective* is a one-two year milestone for achieving the goal, specifying who will be responsible for its execution. The focus is on the results or outcomes of taking action, not on outputs. An output would be the number of persons removed from the welfare rolls but an outcome would be the number of persons removed who had found and retained jobs for one year.

Performance Measurement

It is important that organizations establish a system to track the progress they are making toward achieving both their goals and their objectives. The use of performance measures is the leading means of monitoring management improvement and by themselves create powerful incentives to influence organizational and individual behavior. The GAO found that organizations successful in measuring their performance developed measures based on these four characteristics: (1) they were tied to organization goals and demonstrated the degree to which the desired results were achieved; (2) they were limited to a vital few that were considered essential for producing data for decision-making; (3) they were responsive to multiple priorities; and (4) they were responsibility-linked to establish accountability for results. In addition, the data that was collected was sufficiently complete, accurate and consistent to be useful in decision-making.

The process of performance measurement, and different methodologies, is described in more detail in the next section of this report.

Monitoring and Reporting

There seems to be widespread consensus that in order to implement principles of continuous change, results-oriented operations, business practices re-engineering, management improvement or outcome-based accountability, the performance data gathered must actually be used by managers. In the case of the federal government, the GPRA requires that each agency report annually to the President and to Congress on the extent to which it is meeting its annual performance goals and the actions needed to achieve those that have not been met. The GAO suggests that performance reports will be more useful if they:

- Describe the relationship between the agency's annual performance and its strategic goals and mission,
- Include cost information,
- Provide baseline and trend data,
- Explain the uses of performance information,
- Incorporate other relevant information, and
- Present performance information in a user-friendly manner.

Providing information on the relationship between annual performance and strategic goals enables customers and stakeholders to see the relationship between short-term accomplishments and the agency's long-range goals and reason for being. Including unit costs per output or outcome enables the agency to demonstrate the cost-effectiveness and productivity of its program efforts. Providing baseline and trend data gives decision-makers the ability to compare performance over time. Explaining what action the agency has taken based on the data enables decision-makers to determine what actions they may need to take to improve performance.

The success of strategic planning depends on how the information generated by the process is used. If the mission and goals are clearly communicated to managers and employees, they should be expected to know and understand agency expectations. However, it is essential that executive and legislative decision-makers utilize performance measurement data in their policy, program and resource allocation decisions. If employees and managers know that the information they generate to support the achievement of goals is not being used, or even worse, being used to penalize them, then the strategic planning process will have fallen far short of its potential in achieving results-based accountability.

PERFORMANCE MEASUREMENT/ BENCHMARKING

"Hours after the last familiar sign, the driver kept up a steady pace. 'We're lost, aren't we?' said the passenger. 'Yes,' said the driver, 'But we're making good time, don't you think?"[4]

Taxpayers expect government to be accountable for the use of the monies it provides. In the past governmental accountability was determined by defining how money was spent, on which programs and on what (in terms of personnel, equipment, supplies, buildings, and other defined *objects* of expenditure). The focus had been on process (were proper rules and procedures followed for spending the money, awarding the contracts, tracking expenditures) and staying within appropriated amounts. Fiscal audit and budget reports have been designed to reflect this focus. Now, however, governmental accountability has been redefined to focus on results: what taxpayers are getting for their monies in terms of benefits to their lives and the lives of others they care about and how efficiently and effectively those funds are used. Government is to be held responsible not only for its actions but for the results of those actions and this has required the development of new measurement and reporting systems, alternately called "performance measurement systems," "performance accountability systems" or "outcome measurement systems." Whatever the system is called it consists of a permanent data collection and reporting system established to monitor and improve the results of government policies and programs.

Essential components of performance measurement systems for specific government programs:

1. *Identifying desired outcomes.* This typically consists of the application of the strategic planning process where an agency identifies the outcomes it wishes to achieve through its programs.

2. *Selecting measures or indicators.* It is important to use only a few selected indicators. A good description of these has been developed by GASB as shown in Exhibit 4.

3. *Setting standards for performance and outcomes.* Actual program outcomes or results are compared to some agreed upon standards, such as the following:

- Previous performance,
- Performance of similar organizations,
- Performance of the best organizations (called "benchmarking" and described more fully later in this section), or
- Pre-set targets.

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[4] Anonymous quotation as cited in Mark Friedman, *A Guide to Developing and Using Performance Measures in Results-Based Budgeting*, The Finance Project, Washington, DC, May, 1997.

4. *Reporting results.* Regular public reporting is essential using a report format and including content that is tailored toward the intended audience (decision makers or the general public).

5. *Using outcome and performance information.* The information generated should be used regularly (a) in program planning to reevaluate goals and objectives and to adjust priorities; (b) in managing for results to promote continuous improvement in program operations and results; and (c) in performance budgeting systems. [5]

The Balanced Scorecard

The balanced scorecard is considered by many to be the next generation of performance measurement. The business sector, long engaged in utilizing performance measurement to judge effectiveness, developed the concept of looking at several sets of measures (rather than just financial measures) to see how well their organization is doing overall. The three sets of key measures are financial (for example, the current ratio of return on net worth), customer-focused (such as satisfaction level and number of complaints) and internal operations (productivity, for example). A specific fourth measure is added to focus on the peculiar interests of the specific industry.

The "balanced scorecard" concept is quite new[6] and its usefulness in the public sector not fully tested. The intent is to recognize that performance measures need to have a strategic context emphasizing user value-added, rather than just economic concepts (like productivity) and financial constructs (cost effectiveness). Focusing on financial performance explains the past but a balanced scorecard focuses on the future. One proponent, and user of the concept is the City of **Charlotte, North Carolina**. There key business managers were directed by the budget office to include a balanced score card report in their requisite business plan and the budget office uses it to evaluate how the city is doing overall, compared to its goals, and to identify activities that do not add value to the achievement of those goals.

Another View

Most of the literature about performance measurement recommends that it be implemented as part of a results management system which begins with strategic planning and continues with performance measurement, performance budgeting, and accountability reporting and evaluation. A different view is taken by Mark Friedman who directs the Fiscal Policy Studies Institute in

[5] Michael D. Campbell, "Outcome and Performance Measurement Systems: An Overview," *Alliance for Redesigning Government*, National Academy of Public Administration, n.d.

[6] Attributed to Robert S. Kaplan and David P. Norton as described in their article, "Using the Balanced Scorecard as a Strategic Management System," in *Harvard Business Review*, January-February, 1996, pp. 75-85.

Baltimore. He maintains that organizations are completely justified in skipping past mission, vision, values, purpose, goals and objectives and going directly to the development and use of performance measurement. He argues:

> *There is no reason to start with agency mission. It can, in fact, be argued that, by working* ***down*** *from results and* ***up*** *from programs, agency mission statements become a by-product of this work. Mission statements and their attendants, retainers, and attorneys help articulate why the agency exists--how it contributes to improving results--and generally how it goes about doing this. But there is no reason to wait for the perfect articulation of mission before getting about the business of selecting performance measures....By going straight to the business of selecting performance measures, we ease the frustration and associated cynicism that go with complex planning processes.*[7]

Dr. Friedman also suggests that there has been developed an over-elaborate classification of kinds of performance measures (see, for example, the delineation of GASB, shown in Exhibit 4) which often do not distinguish between results, indicators and performance measures thereby creating unnecessary complexity. He postulates a simplified four-quadrant approach. This categorization is shown in Exhibit 1.

[7]Mark Friedman, *op.cit.*, p. 8.

Exhibit 1
Performance Measures

QUANTITY	QUALITY	
How Much Service Did We Deliver? How much effort did we put into service delivery? How hard did we try? *(Least Important)*	**How Well Did We Deliver Services?** How well did we treat our customers? Was service courteous, timely, accessible, consistent, etc?	I N P U T
How Much Did We Produce? How many clients or customers showed an improvement in well-being? How much do we have to show for our services?	**How Good Were Our Products?** What percentage of our clients or customers showed improvement? What do we have to show for our service in terms of output quality? *(Most Important)*	O U T P U T

Source: Adapted from charts in Mark Friedman, *A Guide to Developing and Using Performance Measures in Results-Based Budgeting*, The Finance Project, Washington, DC, May, 1997.

In his view not all questions are equally important; those that measure quality are more important than those that measure quantity; and it is not enough to count effort, effect must also be measured. Thus the lower right quadrant questions are the most important and the upper left the least important.

Exhibit 2 is an example of performance measures for education using Dr. Friedman's categorization.

Exhibit 2
Education Performance Measures

	QUANTITY	QUALITY
INPUT	- How many students did we serve this year?	- What was our student/teacher ratio? - What percent of our teachers have advanced degrees? - How "rich" is our extracurricular program?
OUTPUT	- How many children graduated? - How many children dropped out?	- What percent graduated on time? - What percent completed advanced placement courses? - What percent entered work or college after graduation? - What were average earnings for our students 2 and 5 years later?

Caution

While performance measurement is being used with increasing frequency throughout the financial community, and the federal government has made a major commitment to its use, as have numerous states and localities, proceeding too quickly and without a plan can result in the production of misleading data subject to misuse. The AGA's Task Force on Performance Auditing issued this caution in its 1993 report:

> *Efforts to improve government performance data systems should continue, but cautiously. We should learn from past failed efforts; and the principal lesson to be learned is that grand designs for big and speedy change will not work. The development of performance data systems should be incremental and their development should undergo periodic assessment and adjustment to ensure that useful (as well as reliable and valid) data are being produced and used. In addition, performance data systems should be developed by teams of people with diverse expertise. Program expertise — policy and administrative—is, of course, important, as is computer processing expertise. It is also important to have people who*

understand the information needs of decision makers, and people well-versed in valid measurement techniques.

It should also be recognized that managers tend to manage according to what they will be held accountable for. Thus, organizations need to be cautious in choosing performance measures to insure that they do not move the organization in an unintended or undesirable direction.

To make performance measurement meaningful, agencies producing the data must know that it is going to be meaningfully used by legislative bodies, top government managers and the public. When performance data becomes part of the oversight and policy-making processes there will be a compelling reason to insure that high-quality data is produced. Budget staff can assist in this process by incorporating this data into the budget process and auditors can do so by incorporating service efforts and accomplishments reporting into financial audits and by utilizing the data in performance auditing. The AGA Task Force recommends that performance data systems be made part of the budget process as the "natural arena to set performance goals and report on results."

It may also be desirable to consider establishing a mechanism to audit the performance measurement system to insure that it meets the needs of decision-makers. It is important that agencies not measure the wrong things in an effort to comply with a centrally-imposed measurement system. It is for that reason that the federal government inserted the GAO as an intermediary between the executive branch and the legislative branch to review agency's compliance with GPRA requirements, including the selection of appropriate performance measures. In **Texas** the audit agency is required to verify and certify the performance measures used by state agencies and in **Multinomah County, Oregon**, the county auditor reviews how the county and its agencies are doing in relation to its benchmarks. In **Prince William County, Virginia** the auditor is responsible for spot-checking the data that departments report as part of their performance based budgeting effort. This suggests a new and different role for auditing agencies in the future.

MANAGERIAL ACCOUNTING

"[T]he accounting systems of today have as much to do with inhibiting progress as any other factor. They're measuring efficiency in a world where effectiveness and quality are the key measurements."[8]

The concepts of redesigning or reengineering business processes and Total Quality Management (TQM) depend upon information generated through accounting systems. The problem is that traditional accounting systems are not sufficiently flexible to provide the kind of information that managers need to determine cost effectiveness — the common ingredient of initiatives designed to focus government on results. It is essential to performance measurement and to competitive contracting. As state and local governments enter these realms, they quickly learn that they do not know what the actual costs of what they do. Activity-Based Costing (ABC) is one of several managerial costing systems that have been used widely in the business sector and is being adopted for use in governments. ABC establishes a costing process which provides financial data about baseline costs of current processes and activities, data that is needed to test alternative process improvement solutions for their cost efficiency and the actual cost savings from improvement projects. Unless governments know what their actual costs are they cannot successfully consider the alternatives of competitive contracting.

The foundation of ABC is its ability to analyze what an organization does, enabling management to center on improvements. To illustrate this, Exhibit 3 shows budget information grouped in the traditional way and in terms of activities. The advantage of the ABC approach is that total costs of discrete processes or activities are portrayed, rather than line items. Thus, managers are provided with information about how their resources are being used and that information can assist them in finding improvements to reduce costs and increase productivity.

[8]Robert K. Shank, "The Emerging Revolution" as quoted in Joseph Kehoe, William Dodson, Robert Reeve, Gustav Plato, *Activity-Based Management in Government*, Coopers & Lybrand L.L.P., Washington, DC, 1995, p. 46.

Exhibit 3
Budget Information in Alternate Views

Traditional View		Activity View	
Salaries Benefits	$900,000	Prepare Collections Procedures	$69,000
Travel Expenses	3,000	Compile Input Data	58,000
Space Rental & Phones	145,000	Verify Input Data	346,000
Contractual Services	93,000	Create Monthly Camera Copy	23,000
Printing & Reproduction	1,000	Print & Distribute Monthly Report	69,000
Training	6,000	Create Annual Camera Copy	12,000
Health Units	3,000	Print and Distribute	23,000
Supplies	1,000	Manage Human Resources	92,000
Equipment	2,000	Perform Admin. Functions	104,000
Total	**$1,154,000**	Perform File/System Admin	92,000
		Provide Training	23,000
		Attend Training	46,000
		Perform Special Projects	115,000
		Report Accounting Data	82,000
		Total	**$1,154,000**

Source: Tracey G. Amos, Cynthia A. Paolillo, Denise A. Joseph, "Enhancing CFO, GMRA & GPRA Implementation with Activity Based Management," *The Government Accountants Journal*, Spring, 1997.

An example of the benefits of ABC in identifying ways of reducing costs or delivering governmental services to citizens more efficiently was cited in a recent article about ABC in *Governing* magazine.[9] In Indianapolis, sealing cracks in a lane-mile of road used to cost $1,200. However, after determining all contributing costs and analyzing them the city was able to reduce that cost to $737.59 by paring working groups from 10 to 6, cutting the number of vehicles used for the job from 3 trucks and 2 trailers to 2 trucks and 1 trailer. The new costs per mile were determined to consist of labor at $352.77, materials at $62.05, equipment at $82.48, vehicles at $54.11 and building and general administration at $186.18.

A cost accounting system should enable a government to determine what it costs to issue a driver's license, a building permit, a college graduate, make an arrest, put out a car fire, dispose of a ton of trash, find a deadbeat dad or deliver any other governmental service. Current accounting systems do not perform that function while managerial costing systems do. Because of federal emphasis on results-driven management the Office of Management and Budget (OMB) has issued directives to federal agencies to adopt such systems.

[9]Jonathan Walters, "A Dollar's Worth of Government," *Governing*, July, 1996, p. 45.

The Office of Management and Budget adopted Statement #4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," on July 31, 1995 to describe the relationship among cost accounting, financial reporting and budgeting. They set forth these five standards to describe the fundamental elements of managerial cost accounting:

- Accumulating and reporting cost of activities on a regular basis for management information purposes.
- Establishing responsibility segments to match costs with outputs.
- Determining full costs of government goods and services.
- Recognizing the costs of goods and services provided among federal entities.
- Using appropriate costing methodologies to accumulate and assign costs to outputs.

The Statement goes on to describe four different forms of managerial accounting. The following is a summary of these different methodologies.

Kinds of Managerial Costing Methodologies

ABC is based on the premise that an output requires activities to produce goods or services and activities consume resources. Using this premise cost drivers are used to assign costs through activities to outputs in a two-stage procedure. First, costs are assigned to resources and then activity costs are assigned to outputs. The four major steps involved in the system are: (1) identifying activities performed in a responsibility segment to produce outputs, (2) assigning or mapping resources to the activities, (3) identifying outputs for which the activities are performed, and (4) assigning activity costs to the outputs.[10]

Job Costing is another methodology which accumulates and assigns costs to discrete jobs (meaning products, projects, assignments, or a group of similar outputs). This method is especially appropriate for responsibility segments that produce special order products such as legal cases, audit assignments, research projects and repair work. Each job is given a code number and resources spent are identified with the job code with costs that cannot be directly traced assigned to jobs either on a cause-and-effect basis or allocation basis.

[10] A good explanation of the operation of this costing system is found in Robin Cooper, Robert S. Kaplan, Lawrence S. Maisel, Eileen Morrissey, and Ronald M. Oehm, *Implementing Activity-Based Cost Management*, Institute of Management Accountants, Montvale, N.J., 1992.

Process Costing is a methodology appropriate for use in producing goods or services that have these characteristics: (1) the production involves a regular pattern of process, (2) its output consists of homogeneous units, and (3) all units are produced through the same process procedures. This method would thus apply to such activities as making entitlement benefit payments which involves a series of consecutive processes for reviewing applications to establish client eligibility and for computing the amount of benefits and issuing checks. Under this methodology an organizational division accumulates costs, assigns the costs to its outputs and calculates the unit cost of its output. For each reporting period the division prepares a cost and production report showing the costs, the completed units and the work-in-process volume. When a certain number of completed units are transferred from the division to the next division, the costs of those units are also transferred and eventually incorporated into the costs of the end product. The cost flow follows the physical flow of the production and the unit cost of the end product is the sum of the unit costs of all of the divisions involved in producing the product or service.

Standard Costing is usually used in conjunction with ABC, job order costing or process costing. It can be applied to specific outputs or activities and can also be applied to a responsibility segment in aggregate by comparing total actual costs with total standard costs based on outputs produced within a certain time period. It involves outlining how a task should be accomplished in nonfinancial terms such as minutes or square feet and how much it should cost. As work is underway, actual costs incurred are compared to standard costs to reveal variances and identify better ways of accomplishing objectives. Typical uses would be for operations that produce services or products on a consistently repetitive basis.[11]

While the use of the various kinds of managerial accounting systems is not yet being widely used in state and local governments, the promulgation of Statement #4 by the OMB for use by all federal agencies will undoubtedly lead to wider use. States and localities that have been engaged in performance measurement activities are increasingly using managerial costing. Texas, for example, has begun to calculate aggregate costs for certain types of services such as licensing activities and for certain service recipients such as children's programs. The state is calculating the costs of moving students in the state's schools for the blind and visually impaired into self-sufficiency and thus doing unit costing. Also, Milwaukee has initiated a pilot ABC project to cost street services.

Managerial Costing and the Accounting Profession

The government accounting profession relies on the Government Finance Officers Association (GFOA) and GASB to lead in establishing accounting principles and standards for application in

[11]Standard costing is explained well in Charles T. Horngren and George Foster, *Cost Accounting, A Managerial Emphasis*, 7th ed., Prentice Hall, Englewood Cliffs, N.J., 1991.

governmental entities. In 1984 the GFOA published a report titled *Costing Government Services: A Guide for Decision Making*[12] citing the goal of the book as encouraging the use of cost *analysis* in managerial decision-making. Cost analysis and cost accounting are distinguished in the book. The Municipal Finance Officers Association defines cost accounting as "that method of accounting which provides for assembling and recording all of the elements of cost incurred to accomplish a purpose, to carry on an activity or operation, or to complete a unit of work or a specific job."[13] GFOA suggests that the information provided by a cost accounting system ("if one is available") is used in cost analysis, but that cost analysis adds the dimension of focusing on the definition of the service to be provided.

A cost analysis is of use to management in making decisions that will affect the future and the information about past experience provided by cost accounting is used to provide a reasoned basis for change. Nevertheless, the accounting profession considers cost analysis only a part of budgetary reporting, not as an official standard for accounting. According to Rhoda Icerman, a professor of accounting at Florida State University, ABC is "value-laden, so accountants would have to make choices, and they'd just as soon hold this halo of objectivity over their heads and say, 'Just give me facts,' when ABC would force them to make choices about where to lay certain costs."[14] GASB's statement on the subject is found in Concepts Statement No. 1, May, 1987 which sets forth the following financial reporting objectives:

1. Financial reporting should assist in fulfilling government's duty to be publicly accountable and should enable users to assess that accountability by:
   a. Providing information to determine whether current-year revenues were sufficient to pay for current-year services
   b. Demonstrating whether resources were obtained and used in accordance with the entity's legally adopted budget, and demonstrating compliance with other finance-related legal or contractual requirements
   c. Providing information to assist users in assessing the service efforts, costs, and accomplishments of the governmental entity
2. Financial reporting should assist users in evaluating the operating results of the governmental entity for the year by:
   a. Providing information about sources and uses of financial resources
   b. Providing information about how it financed its activities and met its cash requirements

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[12]Joseph T. Kelley, *Costing Government Services: A Guide for Decision Making*, Government Finance Research Center of the Government Finance Officers Association, Chicago, 1984.

[13]Municipal Finance Officers Association, *Governmental Accounting, Auditing, and Financial Reporting*, Municipal Finance Officers Association, Chicago, 1980.

[14]*Governing, op.cit.*

   c. Providing information necessary to determine whether its financial position improved or deteriorated as a result of the year's operations

3. Financial reporting should assist users in assessing the level of services that can be provided by the governmental entity and its ability to meet its obligations as they become due by:
   a. Providing information about its financial position and condition
   b. Providing information about its physical and other nonfinancial resources having useful lives that extend beyond the current year, including information that can be used to assess the service potential of those resources
   c. Disclosing legal or contractual restrictions on resources and the risk of potential loss of resources.

It is probably unlikely that managerial costing will become a mandatory part of state and local government accounting practices in the near future. However, its use is spreading as a result of the new focus on results-driven accountability and the systems that have been developed to accomplish that. Several states have also enacted legislation to require reports the generation of which necessitate ABC or a similar form of managerial cost accounting and analysis and localities are also using them in addition to state-prescribed accounting systems. Further, there is strong movement toward mandating such systems in the federal government.

The origin of OMB's Statement #4 was work undertaken by a task force of the Federal Accounting Standards Advisory Board (FASAB), established in October, 1990 to consider and recommend accounting principles for the federal government. The statement is a combination of concepts and standards. Within the accounting profession "concepts" are considered more general than "standards" which are intended to be specific guidance and authoritative in nature and thus are more in the nature of suggestions. It is significant that FASAB established as a standard the requirement that each reporting entity in the federal government establish cost accounting systems and procedures for its activities in order to ensure the generation of required cost information. They also listed ten minimum criteria that should be met by all managerial cost accounting systems including these six that were concerned with ensuring that the cost data produced was reliable, consistent, and useful: (1) ensuring the ability to assist in measurement of performance, (2) reporting information on a timely and consistent basis, (3) integrating cost accounting with the standard general ledger, (4) determining a reasonable and useful level of data precision, (5) accommodating special information needs of management, and (6) documenting the system through a manual or handbook.

FASAB recognized that other accounting standard-setting organizations have stated only what information is required and how that information is displayed in financial statements but determined that FASAB "should not be constrained by what other standard-setters do." They explained that the main concern of those setting standards for state and local governments is their mission of assuring that the financial position and results of operations are presented in a fair, reliable, and consistent manner to financial statement users who are external to the reporting entity. However, FASAB determined that some of the users of federal government financial reports are internal to the government and that they need access to cost information that is available in commercial enterprises. "In addition, the Board views cost accounting information as vital to both internal and external users." This is especially the case as a result of Congress' enactment of the Chief Financial Officers Act of 1990 and the Government Performance and Results Act of 1993.

Whether or not GASB chooses to modify its standards to apply the same principles for managerial cost accounting for state and local governments as FASAB has for the federal government, some form of cost accounting is essential for units of government moving towards results-driven management. Managerial costing is important for internal operations as necessary components of performance measurement, benchmarking and performance budgeting and, whether required or not, increasing use of these systems will occur as more entities focus their management objectives towards outcomes and results.

ACCOUNTABILITY IN BUDGETING

"Legislators too often end up micro-managing because much of the information that they have at their disposal delivers up administrative minutiae rather than cogent analysis of broad trends and emerging issues. A system of results-based budgeting can begin to supply policy-makers with the tools that they need to respond more effectively to what communities want as well as provide them with the political support that is needed to make tough choices."[15]

A leading proponent of performance budgeting, Jesse Burkhead, defines a performance budget as one which represents the purposes and objectives for which funds are required, the costs of the programs proposed for achieving those objectives, and quantitative data measuring the accomplishment and work performed under each program. What this means is that government agencies specify the outputs and outcomes that are to be produced by the operation of their programs and services and then set targets for achievement which become the basis for their budget requests. In traditional budgeting the focus is on the unit cost of achieving a particular outcome while in performance budgeting the focus is on the unit cost of providing a service. In performance budgeting, the budget becomes a performance contract between the agency and elected officials. A case study of how one community adopted performance budgeting will help to illustrate its operation.

[15] Atelia I. Mealville, *A Guide to Selecting Results and Indicators: Implementing Results-Based Budgeting*, The Finance Project, Washington, D.C., May, 1997.

Case Study[16]

In 1992 **Catawba County, North Carolina**, with 120,000 residents and 800 employees, decided to implement the principles described in David Osborne and Ted Gaebler's book, *Reinventing Government*, by changing its budget process from focusing on inputs and dollars spent to outcomes. They began by selecting six volunteer departments and eliminating the voluminous justification process and permitting them to move funds as needed to meet service demand. They were also given discretion to create, delete, split and reassign positions as needed within the total available funds. Departments were allowed to keep any unspent funds and any over collected or new revenues and use them to enhance services and meet agreed-upon outcomes (creating a form of investment capital). Instead of analyzing the dollars spent for each line item, the emphasis was changed to analyzing the impact that service had on the community as articulated in outcome statements. Instead of saying that "1,000 building permits will be issued," the building and grounds department stated that "95 percent of an estimated 1,000 building permits will be issued within 48 hours of receipt of request, and 95 percent of building permit recipients will rate the service as at least satisfactory, as determined by a random customer survey." This statement focuses on the entire budget process on the recipients of the service.

In the revised budget process the agency was given its allocation based on its revenue projections but then budget analysts negotiated with each department on the outcomes and how the agency would achieve them. Once the outcomes were agreed upon the departments prepared their budgets according to their own discretion. The six departments averaged increases of 1.85 percent over their current budgets compared to an average of 8.01 percent for all other departments. Here are three reported examples of what kinds of things were made possible through the reformed budget process:

- Emergency medical services managers decided that to achieve their outcomes they would need a training officer but could not afford one within their allocation. They contacted a local hospital and it agreed to provide transportation for heart catheterization patients for $60,000 in EMS revenues which were used to fund the training officer and also set aside funds for future capital needs.

- The health department looked for more aggressive ways of collecting Medicaid fees for which it was eligible and added a specialized insurance clerk with on-line billing capabilities thereby increasing revenues by $200,000.

[16]This is an adaptation of the case study reported by Judy Ikerd, Budget Director of Catawba County, North Carolina in Stuart S. Grifel's article, "Organizational Culture: Its Importance in Performance Measurement," *Public Management*, September, 1994.

- One of three full-time budget staff members was eliminated when the cumbersome analysis and justification process was eliminated.

It appears that the new budget process resulted in increased agency resourcefulness as a result of their new budget flexibility and that employees developed a sense of ownership and responsibility towards achieving their outcome expectations because they played a major role in their development.

Several states have fully integrated their performance measurement systems into the budget process. The systems used in Arizona and Texas provide illustrative examples of two different ways of dong this.

Arizona

In 1993 the Arizona Legislature enacted the Arizona Budget Reform Act requiring formal identification of all state programs, the development of strategic plans and the identification of performance measures to support budget requests. In 1995 the law was amended to require using that information to evaluate program efficiency and effectiveness through the conduct of legislative program reviews. Most recently the state amended its operating budget instructions to link budget requests to agency strategic goals. They use Program Authorization Reviews (PAR's) to systematically examine agency's program performance. During 1997, the central budget office examined 30 selected programs and sub-programs in 14 agencies asking these questions:

- How does the mission of the program fit with the agency's mission and the program's enabling authority?
- Does the program meet its mission and goals efficiently and effectively, including comparison with other jurisdictions?
- Do the program's performance measures and performance targets adequately capture these results?
- Are there other cost-effective alternative methods of accomplishing the program's mission?

Budget analysts are increasingly relying on efficiency, quality and outcome measures, included in the budget request, in analyzing agency budget requests and presenting alternatives to the Governor and the Legislature. Arizona is a good example of using performance measurement in budget decision making without unduly complicating the process or overloading the budget document with unnecessary data.[17]

[17] Aimee L. Franklin, "Managing for Results in Arizona State Government: Arizona Budget Reform Implementation," presented at the 7th Annual Conference on Public Budgeting and Finance, 1996.

Texas

Texas first became interested in performance budgeting as a way of determining whether monies invested in programs were achieving their intended purposes. In 1991 Texas transformed its budget process to a full-scale performance budget as part of its Planning, Budgeting, Implementation and Evaluation System. The System six major objectives:

- To focus the appropriations process on outcomes.
- To enhance monitoring of budget and performance.
- To establish standardized unit-cost measures.
- To simplify the budget process.
- To provide rewards and penalties for success and failure.
- To assure the accuracy of measurement data through a review and certification process located in the State Auditor's office.

Results management in Texas begins with five-year strategic plans developed in each of the state's 274 state agencies. Those agencies established 800 goals , 1,623 objectives and 2,560 outcome measures, all of which are reported in a document titled *Texas Tomorrow*. But the state recognized that it would be impossible to make decisions with that many indicators to review and so to make more meaningful decisions they established five mission statements for the state with 15 goals with 107 performance indicators of success organized in nine functional areas. The mission statements are quite broad: (1) providing education; (2) enhancing the health, well-being and productivity of the citizenry; (3) protecting the environment and managing the state's natural resources; (4) building a solid foundation for social and economic prosperity; and (5) public safety.

Agency budget requests include their strategies, the costs of meeting particular strategies and accomplishing output targets and these become the line items of appropriation. The strategic plans are printed in the appropriations bill with specific performance targets so that the appropriations bill is used as a contract between the agency, the legislature and the governor that a specific level of performance is going to be achieved in return for a specific dollar amount of appropriation. The budget request represents the cost that an agency puts on meeting its strategic plan.[18]

An important part of the process is the report and evaluation mechanism. There are quarterly and annual reports on performance submitted to the central budget agency, the legislature and the State Auditor. Texas conducts the most comprehensive performance evaluation of agency

[18]Dale Craymer, "Texas' Shotgun Marriage of Strategic Planning & Performance Budgeting," *Managing for Results: Advancing the Art of Performance Measurement,* Conference Proceedings, November 1-3, 1995, Austin, Texas.

programs in the nation. The most recent biennial review, prepared by the Texas State Auditor, identified $1 billion in savings recommendations.

A number of communities use performance measurement in their budget systems in unique ways:

- **St. Petersburg Beach, Florida** and **Phoenix** compare performance to targets with monthly and annual reports and Phoenix also uses a customer-satisfaction survey biennially;
- **Indianapolis** publishes a public budget document, sometimes called a "popular budget," stating in clear, simple language how resources are allocated along with departmental goals and accomplishments; it also uses performance data as a factor in determining pay increases.
- **Virginia Beach, Virginia** has an elaborate Total Quality Management system in place which employs performance measurement and performance budgeting;
- **San Mateo County, California** uses performance-trend information in its budget documentation and decision-making;
- **Milwaukee** requires city agencies to specify how the monies allocated for important activities will affect its residents, combining activity-based costing and performance measurement.[19]

Caution

While the use of performance measurement in budgeting is widely recommended as a critical component in results management, there is no clear answer to how decision makers should use the information. If an organization produces well-documented results with fewer inputs because of the sound application of strategic planning should that organization receive fewer financial resources or more? If the agency/program is rewarded with more resources it can be argued that poor performers will be denied the resources they need to improve their performance and reach the level of achievement expected or achieved by the good performer. Concomitantly, it can be argued that providing more resources to the poor performer will demoralize the good performer and hinder its further improvement. It is appropriate to recognize and understand that failure to identify the outcomes of good performance will result in skepticism of the process:

> *Government employees correctly see that performance metrics can pose substantial risks. By exposing performance to easier scrutiny, measurement may lead to games of "gotcha." Those who stress cost-effective performance may fare less well than*

[19]Mark Friedman, *op.cit.*, pp. 28-29.

those who play traditional "Washington Monument" games or hide fat in obscure accounts in the fight for budget resources.[20]

It can be argued, however, that the benefit derived from enhanced public confidence in governmental institutions through the use of performance measurement should result in the reduction of micro management by central budget agencies and legislative bodies and this, in turn, will serve to justify the need for public resources. This effect can be enhanced by giving adequate attention to:

- Communicating the measures throughout the organization, by using graphical as well as numerical displays.
- Engaging employees in dialogue about the new measures.
- Using feedback to improve measures where possible.
- Reexamining measures for balance including the mix of leading and lagging indicators.
- Establishing baseline data and performance goals.
- Celebrating progress where measures document such.
- Creating a culture in which all systems, especially new ones, automatically contain reasonable performance measures.[21]

But the usefulness of even the most sophisticated performance measurement and budgeting systems rests largely with budget-makers and how they use the data developed. If it is used to punish, rather than reward, the benefits from the system are likely to be far less than if the measures are used by government employees for self correction and continuous improvement without risk of punishment and with some prospect for reward.

Another important consideration is how decision makers choose alternatives in the allocation of limited resources. If an agency proposes an increase in spending for a highway safety program, with an anticipated result of increased numbers of lives saved, and another agency proposes improvement in the number of students passing a proficiency test, for the same investment, how is a budget decision-maker to decide which investment to choose? Recognizing the importance

[20]Jay E. Hakes, "Performance Measures and Organization Change," *PA Times*, Vol. 20, No. 7, July, 1997, p.10.

[21]*Ibid.*

of this issue the Alliance for Redesigning Government has recommended a process called "investment decision-making."

Investment Decision-making[22]

This process proposes combining program outcome measurement with jurisdictional benchmarking and adds a mechanism for estimating the return on investment for public spending — a critical ingredient to aid decision-makers in making choices on where to allocate resources. The Alliance for Redesigning Government offers the following example of how the process would work.

Assuming a community benchmark of reducing the percentage of families living in poverty from a current level of 10.1 percent to 2.0 percent in the year 2010, there might be two alternative governmental initiatives. One would have a goal of moving 50,000 poor families out of poverty through a combination of job training programs, tax incentives to employers, and individual development accounts while another would seek to prevent the formation of impoverished families by a combination of health, education and mentoring programs that would reduce the number of teen births from 3,300 per year to 600 per year. The investment decision-making process recommends estimating the cumulative monetary value of achieving each type of outcome calculating this value at three levels:

- For the individual (increase in earnings, avoidance of child care costs)
- For government (increase in taxes paid, decrease in welfare expenditures); and
- For society (increased domestic spending, reduced crime).

In addition, performance-based budgeting would provide estimates on the average unit cost to the government for each outcome. Comparing the cumulative value of the outcome to the cost, the return on investment to the individual, government and society can be calculated. The decision-maker will then be able to determine whether the value of the outcome over time substantially outweighs current costs of the program or service. If one of the strategies offers a much greater return on investment, then decision-makers might be justified in shifting priorities and spending more in that area.

Requiring the reporting of unit costs of outcome also allows decision-makers to determine whether particular programs are good investments through requiring reporting on unit costs per outcome. An example would be if a job placement service has a low cost per client served but a

[22]This section is based on information provided by the National Academy of Public Administration Foundation in its review of materials included in Jack Brizius and The Designing Team's book, *Deciding for Investment: Getting Returns on Tax Dollars*, Alliance for Redesigning Government, National Academy of Public Administration, 1994.

high unit cost per outcome because very few of its clients find jobs that will move them out of poverty but a high cost apprenticeship program is highly successful in placing its graduates in good jobs. An investment in the latter might be justified in meeting a goal of moving 50,000 families out of poverty or finding a new job placement agency with a lower cost per outcome would be an alternative.

Several states have begun to use investment decision-making in their budgeting systems currently. **Iowa** is testing investment budgeting in its workforce development programs. **Florida's** Department of Health and Rehabilitative Services is phasing the process in over five-years as a means of complying with its Performance Budgeting and Accountability Act of 1994.

SERVICE EFFORTS AND ACCOMPLISHMENTS REPORTING

"An objective of GPEFR (General Purpose External Financial Reporting) is to provide users with information that will assist them in assessing the performance of the reporting entity. Because the primary purpose of governmental entities is to maintain or improve the well-being of their citizens, information that will assist users in assessing how efficiently and effectively governmental entities are using resources to maintain or improve the well-being of their citizens should play an important role in GPEFR...SEA (Service Efforts and Accomplishments) information is necessary for assessing accountability and in making informed decisions; therefore, to be more complete, GPEFR for governmental entities needs to include SEA information."[23]

The auditing profession, through the leadership of the Comptroller General of the United States, has relentlessly called for systematic reporting of governmental performance. The 1994 revision of the Yellow Book states that performance auditors must ask whether there is a management control system, with management controls for measuring, reporting, and monitoring program effectiveness and whether reported measures are effective, valid and reliable. GASB has formalized the concept of reporting on performance and has promulgated a Concept Statement recommending its use in assessing accountability and in making informed decisions. In the federal government the 1990 Chief Financial Officers' (CFO) Act requires performance reporting by federal agencies. In addition, a number of states and localities have been regularly reporting to decision makers and the public on how well they are doing in achieving defined objectives.

[23]Concepts Statement No. 2 of the Governmental Accounting Standards Board on concepts related to Service Efforts and Accomplishments Reporting, April, 1994.

Oregon Benchmarks

Oregon Benchmarks, published in 1991, is considered the prototype for measuring and reporting on the overall condition of a community. It was developed in order to chart progress toward achieving a strategic vision of what the state should look like in the year 2010. The achievement of these results, at critical target years, required the combined efforts of government, business, philanthropic organizations, volunteer groups, non-profit enterprises, and ordinary citizens, each of which is held accountable for results. Within government individual agencies have specified how they will contribute to the achievement of particular benchmarks. The benchmarks themselves, there are now 272, have been officially adopted by the state legislature.

Florida's Benchmark Report

Florida's Government Performance and Accountability Act of 1994 established a Commission on Government Accountability to the People (GAP) which has worked to establish a state performance budget, reduction in administrative rules, personnel system changes, competitive bidding for state services and, in February, 1996 published *The Florida Benchmarks Report* which identified 32 critical benchmarks to focus on as the state's highest priorities. The criteria for choosing the benchmarks were: (1) the number of Floridians who are affected, (2) the severity or frequency of the problems and (3) how easily the state can do something about them. Among the purposes of the benchmarks is use by the legislature in allocating resources and for cities and counties to use in developing their own benchmarks to solve local problems. In addition, the GAP Commission uses them as the starting point for evaluating agency performance.

Minnesota Milestones

Modeled after *Oregon Benchmarks*, Minnesota Milestones is a long-term effort also begun in 1991. Over 10,000 citizens participated in the process which identified five themes (for example, Minnesota will be a community of people who respect and care for one another) with 20 goals (for example, all children will come to school ready to learn). In 1993 the state passed its Performance Reporting Act covering 21 state agencies with the Legislative Auditor involved in reviewing the reliability of performance measures established by agencies as well as consulting with them. Now each biennium reports on how agencies are performing are widely distributed including being available on-line on "Performs" on the Internet.

What Should Be Reported

In determining what kind of information should be reported the 1990 research report of GASB is helpful. It identifies five kinds of indicators (*input, output, outcome, efficiency and explanatory information)* appropriate for reporting and organizes them in four categories as described in Exhibit 4.

Exhibit 4
Categories of Service Efforts and Accomplishments Indicators

A. Indicators of Service Efforts

1. Inputs-Dollar costs of the service during the period.
   a. In "current" dollars.
   b. In "constant" dollars, that is, adjusted for price level changes.
   c. Per household or per capita, and in either current or constant dollars.
2. Inputs-Amounts of *non*monetary resources expended, especially the amount of work time expended during the period (for the service). These might be expressed in such units as full-time-equivalent years or employee-hours.

B. Indicators of Service Accomplishments

1. Outputs-Amount of workload accomplished.
2. Outcomes-A numeric indicator of program results. This category includes indicators of service quality (such as timeliness), effectiveness, and amount or proportion of "need" that is (or is not) being served.

C. Indicators That Relate Service Efforts to Service Accomplishments

Note: These can also be labeled efficiency indicators (the term *productivity indicator* is sometimes used instead of *efficiency indicator*. Productivity is usually defined in the productivity literature as "output divided by input," the reciprocal of "input divided by output") which include both input/output and input/outcome indicators.

1. Amount of input related to (divided by) amount of *output*. "Input" can be any of the variations included under Section A, and "output" refers to B.3., *not* B.4.
2. Amount of input related to (divided by) amount of *outcomes or results*. Again, "input" can be any of the variations noted in Section A. "Outcome" refers only to B.4, *not* B.3.
3. Productivity (or efficiency) *indexes*. These traditionally have been used in reporting national productivity trends. Indexes are calculated by relating the ratio of productivity in the current year to that of a preselected base year. These indexes have the advantage that the productivity ratios for different activities for a service, or across services, can be combined by weighting each ratio by the amount of input for each activity.

D. Explanatory Information

This is a term used to cover a variety of information relevant to a service that helps users understand the performance on the SEA indicators and factors affecting an organization's performance. The explanatory information should be grouped into two categories:

1. Elements substantially outside the control of the public agency, such as demographic characteristics.
2. Elements over which the agency has significant control, such as staffing patterns.

Source: *Service Efforts and Accomplishments Reporting: Its time Has Come; An Overview*, ed. By Harry P. Hatry, James R. Fountain, Jr., Jonathan M. Sullivan, Lorraine Kremer. Governmental Accounting Standards Board of the Financial Accounting Foundation, Norwalk, Connecticut, 1990, pp. 12-13.

PERFORMANCE AUDITING

There is a certain amount of variation within the auditing profession about the definition of performance auditing, its scope and what is considered material and thus worthy of audit and measures of success. The variation in defining scope results from the dual origins of those engaged in performance auditing:

> *Auditors with a traditional accounting background developed an approach that emphasizes "economy and efficiency" concerns, while those trained in social science developed an approach that emphasizes questions about program goals and results. In fact, some audit organizations that are strongly oriented toward social science refer to their work as "program evaluation."*[24]

The Comptroller General of the United States, as head of the U.S. General Accounting Office (GAO), sets forth generally accepting auditing standards for audits of government organizations, programs, activities, and functions in a book titled, *Government Auditing Standards*, generally referred to as "The Yellow Book." The Yellow Book separates performance audits into "economy and efficiency" audits and "program audits". This distinction has been criticized by the Association of Government Accountants (AGA) for being misleading and implying that there are only two kinds of performance audits and that there is uniformity among audits conducted under these labels. They suggest a preferable approach is to identify a continuum of questions that *might be* (though all do not have to be) addressed in a performance audit with the auditors setting the scope of the audit to include those questions that are of concern to decision makers. According to the AGA, the continuum of possible questions that could be addressed in a performance audit are:

- Compliance with applicable laws, rules and other authoritative and relevant standards.
- The efficient allocation and use of resources.
- The performance of management.
- The cost-effectiveness of alternative methods of service delivery and goal attainment.
- The reliability of information provided by management.

[24] *Report of the Task Force on Performance Auditing* to the Association of Government Accountants, February, 1993.

- The administrative and organizational design of programs.

- The results of programs and activities and their impact on recipients.

- The achievement of program and/or organizational goals and objectives.

These questions are broad and all-inclusive and permit variations in performance audits which move from compliance auditing through economy and efficiency auditing and up to auditing for results or achievement of goals and objectives.

Another important concern of the AGA is the Yellow Book's definition of determining "materiality and/or significance" which focuses on the level of money involved and internal control and compliance concerns. The AGA suggests that the financial auditing bias of the Yellow Book results in too narrow a definition of what should be audited and recommends that recognition be given to risk or impact on persons external to the agency.

The basic questions to be answered by a performance audit are (1) whether an agency is being run as efficiently as it could be; (2) whether an agency program meets the needs of the public; and (3) whether the agency or program is providing services as the legislative body which created it intended. Thus performance auditing contemplates a review of agency or program *operations* (determining if it is operating at the least possible cost to the taxpayer; *results* (determining if agencies are programs are meeting their objectives; and *compliance* (determining if administrators are doing what legislators intended).

In its report to the AGA, a special Task Force on Performance Auditing concluded that performance auditors should seek to have impact through their audit reports and to do so they need to pay attention to three key elements: audit scope, work quality and report communication, meaning:

- Performance audits must be designed to respond to the specific information needs and concerns of decision makers thus requiring a more complex process than a traditional approach to scope-setting including direct dialogue with legislative and executive decision makers.

- Performance auditors must be nonpartisan and free of any constraints or affiliations that would impair their independence and objectivity and their fact finding must be objective and thorough and conclusions and recommendations must be well-reasoned and supported by evidence presented in the report.

- In order to be effective the audits must be effectively communicated both in terms of clear concise writing and discussions with decision makers.

Because of the variations in the scope of performance audits some jurisdictions call them by other names based on their emphasis: "program evaluations," "expenditure reviews," and the like. Here are some of the programs now underway in states that focus on auditing for performance and results.

Minnesota: Benchmark Reviews

> *To perform best practices reviews, the legislative auditor through the program evaluation division shall examine the procedures and practices used to deliver local government services, including municipalities and counties, determine the methods of local government service delivery, identify variations in cost and effectiveness, and identify practices to save money or provide more effective service delivery. The legislative auditor shall recommend to local governments, service delivery methods and practices to improve the cost-effectiveness of services.*---Minn. Laws (1994) Ch. 632, Art. 3, secs. 15-16.

Under statutory direction the Minnesota Legislative Auditor conducts "best practices reviews" of local governments which examine specific governmental services and compare the performance of those services with cost-effective and innovative practices in order to create a framework for benchmarking future performance. Instead of focusing on organizational and performance *deficiencies*, which is a more traditional audit approach, the best practices approach collects and highlights evidence of success in delivering services, defining success as achieving the highest level of desired effectiveness at the lowest cost. Statewide forums are conducted to disseminate best practices information to local governments so the report is viewed as a means of conveying information.

Benchmark review topics are selected based on recommendations of an advisory council comprised of local government officials which consider criteria such as the potential for improvement and cost savings, data availability and research feasibility and timeliness. A consultant who was a practitioner in the service area under review is employed to assist the audit staff in the conduct of the review. The first two projects undertaken were snowplowing and property valuation for tax purposes.

Florida: Internal Auditing

Florida's Chief Internal Audit Act requires agencies to have clearly defined missions, goals and objectives; to develop performance measures; and to measure performance. Measurement is undertaken through inspector generals in the agencies who are required to advise on the development of performance measures, assess the reliability and validity of measures, coordinate audits and investigations, and coordinate activities relating to fraud.

CONCLUSION

While this report provides a summary of the components of a results-based management system and some guidance in their design and operation, there is considerable literature on results-based or performance management systems and their components which can be used to guide Ohio communities interested in their adoption. The experience of other states and communities is especially useful and can be used effectively to avoid unnecessary problems. This report has included information that has resulted from successful applications of all of the different aspects of a performance management system--from strategic planning through performance measurement and budgeting to accountability and reporting. Successful performance management systems seem to have six common characteristics. These were recently identified by the American Society for Public Administration (ASPA) as a result of its analysis of 22 case studies assembled by its Government Accomplishment and Accountability Task Force. They found these to be the common ingredients in achieving success:

1. A long-term commitment to the performance management process and a recognition that it may take three to four years to develop a good system that is useful to managers and elected officials and accepted by the organization. Performance monitoring only begins to become interesting in years four or five as trends develop.

2. It is important to have a vision or plan to communicate why a performance measurement system is being undertaken and how it will fit into the organization's decision-making processes.

3. There must be a commitment by top management to the performance vision.

4. There must be some form of training for employees and managers in performance management, including the basic terminology.

5. There should be direct line operating staff involved in developing performance indicators rather than having them imposed from above.

6. Effective communication between management, staff, and those developing performance indicators, guidelines and requirements for the performance management system must be maintained.

7. Organizations need not "reinvent the wheel"; much work has already been done throughout the country in establishing performance systems and consultations with them may result in easily adaptable indicators and processes.[25]

[25]"Government's Learn about Performance Measurement," PA Times, Vol. 19, No. 8, August 1, 1996.

Throughout the country, states and communities are increasingly turning to performance management systems as a way of determining whether programmatic efforts have been successful and whether their impacts justify their costs. Movement in this direction in Ohio is in its infancy but there are indications that the state legislature is committed to moving quickly to catch up with other states and communities.

The Ohio General Assembly made a commitment to performance review analysis by authorizing the Office of Budget and Management (OBM) to begin conducting performance reviews of selected state programs during the 1996-1997 biennium. OBM worked with selected state agencies in the development of clear program goals, in identifying measurable objectives to determine if desired outcomes are being achieve and in establishing data collection procedures and capabilities necessary to measure the established objectives. As part of six major agencies' FY 1998-1999 budget requests performance review reports were submitted to OBM and those analyses and the performance data supporting it was incorporated into the Executive Budget document. It is expected that this effort will be accelerated in the future.

The Office of the Auditor has also begun issuing financial summary reports comparing key ratios of local governments with each other. The ratios provide indicators of the trends of financial indicators of townships , cities, school districts and counties. They serve to transform financial reports, which are filed with the Office, into meaningful benchmarks to use in determining how one jurisdiction compares to another. Its publication is intended to enable entities to view long-term issues in terms of their own data and that of their peers in order to make better informed budgeting decisions.

In addition, the Ohio General Assembly has recently focused considerable attention on measuring and improving school district performance through the following actions:

- In the FY1996-97 biennium, Am.Sub. H.B. 117 of the 121st General Assembly directed the Auditor of State to undertake a performance evaluation of the Cleveland City School District.

- For the current, FY 1998-99 biennium, Am. Sub. H.B. 215 of the 122nd General Assembly requires the Department of Education to make recommendations to the General Assembly on implementing performance-based incentives for school districts by January 1, 1998; it requires the state's urban school districts to meet performance standards before accessing funds appropriated under the Urban School Initiative; and it provides funds to the Auditor of State to conduct performance audits of the 21 urban school districts.

- S.B. 55 of the 122nd General Assembly, effective November 1997, abolishes the current system of monitoring school performance and replaces it with a new system based on state-established performance standards.

- H.B. 412 of the 122nd General Assembly, also effective in November 1997, permits the Auditor of State to conduct a performance audit of a school district that is in a state of fiscal watch or fiscal emergency and authorizes the Office to review any programs or areas of operation in which the Auditor believes that greater operational efficiencies or enhanced program results can be achieved, excluding an evaluation of school district academic performance.

- H.B. 412 also creates an Office of Educational Accountability and Productivity within the Department of Education which, among other responsibilities, will issue annual report cards for each school district, and for the state as a whole, based on education and fiscal performance data and will use data to set benchmarks for current state and school district academic and operational performance levels, comparing these levels to those in other states, and measuring improvement in Ohio's overall public education system and its status versus other states over time.

In Ohio, as in other states, financial management systems for the 21st century will increasingly be results-driven and outcome-based using the processes described in this report.

Glossary of Terms[1]

ACCOUNTABILITY: Responsibility for performance and results; holding political leaders and agency managers accountable for results against agreed-to performance standards.

ACTIVITY: A unit of work that has identifiable starting and ending points, that consumes resources (inputs) and produces outputs.

ACTIVITY-BASED COSTING (ABC): A set of management information and accounting methods used to identify, describe, assign costs to, and otherwise report on the operations in an organization.

ACTIVITY-BASED MANAGEMENT: Business management in which process owners have the responsibility and authority to control and improve operations, and that uses ABC methods.

BENCHMARKS: In the context of outcomes and performance discussions, the term "benchmarks" refers to desired programmatic outcomes. Benchmarks in this sense should not be confused with the process of "benchmarking," a term used in the context of total quality management and business process reengineering (BPR). Sharon Caudle, in the BPR section of the InfoCoop data base, has defined benchmarking as: "performance comparisons of organizational business processes against an internal or external standard of recognized leaders. Most often the comparison is made against a similar process in another organization considered 'world class'".

BUSINESS PROCESS REENGINEERING (BPR): A concept challenging fundamental assumptions on which an organization is built by radically redesigning its processes, systems and structure around desired outcomes.

EFFICIENCY MEASURE: Measure of the cost per unit of an output or outcome. Examples are: cost per student promoted/graduated; average labor-hours per mile of street resurfaced.

EVALUATION: Use of information from an outcome and performance measurement system to reevaluate outcome goals and objectives and to adjust priorities.

INPUT MEASURE: The resources expended on a program such as the amount of money spent or the total number of employee hours needed to deliver a service.

INVESTMENT-BASED BUDGETING: The process of budgeting government funds in a way that will maximize return on investment in the future by considering the implications of budgetary decisions.

LINE-ITEM BUDGETING: A budget system focusing on objects of expenditure and showing detailed expenditures for each division of government.

MANAGEMENT INFORMATION SYSTEM (MIS): A computerized data-processing system for providing decision support for planning and management.

MISSION: An organization's mission refers to the purposes it serves. By defining its mission, an organization can decide upon appropriate outcomes and performance measures. Mission is often defined through a strategic planning process.

OUTCOME INDICATOR OR MEASURE: Qualitative measures of the results of programs and services. Examples include: the percentage of high school graduates employed or continuing education two years after graduation; the miles of highway in poor, fair, satisfactory, and excellent condition.

PERFORMANCE-BASED BUDGETING: Budgeting which ties resources to outcomes. Instead of allocating resources to achieve quantitative output measures, resources are allocated to achieve qualitative outcomes.

PERFORMANCE MANAGEMENT: The process of defining a mission and desired outcomes, setting performance standards, linking budget to performance, reporting results, and holding public officials accountable for results.

PERFORMANCE MEASURES: Qualitative measures or indicators of progress toward specified outcomes or benchmarks.

PERFORMANCE MEASUREMENT: The process of measuring government performance by tracking progress toward specific qualitative outcomes.

PERFORMANCE STANDARDS: Standards against which to measure performance. Potential standards of comparison include:

- Previous performance, e.g., the percentage of lane miles of roads in satisfactory condition this year compared to last year's percentage.
- Performance of similar organizations, e.g., percentage of graduates from a public high school who attend college compared to the rate for other public high schools.
- Performance of the best organizations, e.g., percentage of public high school graduates who attend college compared to graduates from prestigious preparatory schools. (This is called "benchmarking").
- Pre-set targets, e.g., next year 85 percent of the lane miles of highway will be rated satisfactory or better, and in three years 95 percent will meet this standard.

PROGRAM/PERFORMANCE BUDGETING: A budget system using a format keyed to program structure rather than objects of expenditure and emphasizing the relationship of program objectives and outputs to resources budgeted.

RESULTS-ORIENTED GOVERNMENT: A government that values results and qualitative outcomes over dollars spent and inputs. A government concerned with accountability and performance to meet citizen needs.

STRATEGIC PLANNING: A process of defining the vision, mission, goals and objectives of an organization. Through the planning process, a jurisdiction or agency identifies the outcomes it wants to achieve through its programs and the specific means by which it intends to achieve these outcomes.

TOTAL QUALITY MANAGEMENT (TQM): A formal customer-focused system to support the continuous improvement of the quality of governmental services and operations.

VISION: The ideal mission or a governmental jurisdiction and/or agency and the ideal way it should operate to achieve its mission and best serve the people.

1.These definitions come from several sources including the Alliance for Redesigning Government of the National Academy of Public Administration; Lee M. Mandell, "Performance Measurement and Management Tools in North Carolina Local Government--Revisited," a paper presented at the 57th ASPA National Conference in Atlanta, June 30, 1996; Joseph Kehoe, William Dodson, Robert Reeve, Gustav Plato, *Activity-Based Management in Government*, Coopers & Lybrand L.L.P., Washington, DC, 1995.