

By: John J. Surdick, Ph.D., CPA

Measuring

Financial Performance

with Interperiod Equity

As government financial managers know well, the evaluation of bottom-line effectiveness in governments frequently is hampered by the lack of a strong correlation between the revenues generated and the expenditures/expenses incurred. Interperiod equity is a new measure of financial performance that can help address this problem. In the future, measuring interperiod equity will become an essential benchmark for demonstrating performance and accountability in government financial reporting. The primary guidance in this area is found in the Governmental Accounting Standards Board's (GASB) Statement No. 11, *Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements*,¹ and Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*.²

The Matching Principle

Determining bottom-line effectiveness or profitability in private-sector business enterprises relies upon the accrual basis of accounting and the application of the matching principle, which calls for expenses incurred during a period to be matched with revenues earned during the same period. The resulting difference between these two financial elements yields a measure of net income or net loss for the period, thereby providing management, investors and creditors with a signal as to the financial performance of the organization. In the nonprofit and government sector, interperiod equity (also known as intergenerational equity) is the financial reporting concept that parallels the matching principle and profitability orientation found in private-sector business enterprises.

Interperiod equity is the measure of whether current-year revenues are sufficient to pay for current-year services. A measure of interperiod equity, for example, would show whether citizens received services in the current year but shifted part of the payment burden to future years or used up previously accumulated resources. Such a measure would show whether current-year revenues not only were sufficient to pay for current-year services, but also if they increased accumulated net resources. For example, citizens benefit from the services (such as trash collection) provided by government employees. Current expenditures for these services would include employee wage payments. Related to these wage payments today are the future payments that will be expended for retiree health care and pension benefits. If revenues from current taxation are not sufficient to cover the future retiree disbursements, then future generations will bear the burden of paying for services that did not benefit them. Consequently, interperiod equity would be negative.

Calculating interperiod equity requires comparing the revenues obtained by the government entity against a financial measure of the services it provides. A meaningful comparison requires that the two have some relationship that makes them comparable. Methods used to measure net income for private-sector business enterprises are suited to an environment in which revenues can be matched with expenses and generating profits is a financial performance goal.

In the private sector, many revenues and expenses can be matched because they have a direct relationship to each other. Naturally, private sector business enterprises have numerous costs that do not bear a direct relationship to revenues but can nevertheless be associated with a particular period on the basis of transactions or events taking place in that period, or by allocation. Costs that benefit a single period are recognized in the period incurred. Costs that benefit several periods are allocated to those periods on a systematic and rational basis. Costs that provide no benefit are generally recognized as expenses in the period an asset is impaired or a liability is incurred.

Ordinarily, for most government activities revenues received cannot be matched with the cost of services provided. Most government revenues are obtained from a variety of taxes levied against taxpayers who do not necessarily receive services directly proportionate to the taxes they pay. Frequently,

revenues and services do not result from the same transaction. Revenues obtained from a particular form of taxation can be used to pay for a variety of government services. For example, real estate property taxes can be used to pay for a variety of government services such as police and fire protection, operation of the court system, maintenance of streets and debt service related to financing of a sports stadium.

Interperiod Equity: Time-Period Matching

Although specific government revenues and services frequently may bear no direct relationship to each other, both can be related directly to specific time periods. Consequently, government revenues and services can be related to each other in the aggregate for a particular time period. An operating statement measurement focus that gauges the relationship between aggregate revenues and aggregate services within a particular time period, therefore, is the basis upon which interperiod equity is measured. The relationship of revenues and services to a specific time period can be expressed best by using an accrual basis of accounting because it recognizes the effects of transactions or events when they take place, regardless of when cash is received or paid.

The measure of interperiod equity is inherently oriented to results of operations. Further, the concept of interperiod equity is based on governmental performance goals and the intent of balanced budget laws, both of which focus primarily on operations (the income statement) for the period rather than on financial position (the balance sheet).

However, interperiod equity is not achieved by reporting the proceeds of debt issued to cover current operating expenses as an inflow of financial resources on the statement of operations. Operating debt issued today in order to finance current operating deficits provides no benefit to citizens in the future.

Budgetary and fund accounting practices cause government activities to be spread among a number of funds, therefore, interperiod equity cannot be determined by simply examining the operations of any one particular governmental fund. For example, the debt financed construction of a new fire station could result in the construction monies being accounted for in a capital projects fund, the debt service accounted for in a debt service fund, and the cost of the new building and the bonds payable accounted for in other separately maintained account groups.

To improve upon this situation and to better facilitate the evaluation of interperiod equity, the GASB in Statement No. 34 requires governments to include a Statement of Activities in their annual reports. Similar to the income statement issued by a for-profit business, the Statement of Activities is not based upon fund accounting and is prepared using the full accrual basis of accounting.

The accrual basis of accounting requires recognition of the financial effects of transactions or events even though the cash effect may not take place until well into the future. Although these transactions and events may not result in a current-period inflow or outflow of cash, recognition of their effect on financial resources in the period they take place is a necessary

element in measuring interperiod equity. Examples of the effect of accrual accounting on financial resources include the recognition of increases in assets such as future receivables that have been earned during the current period and the recognition of increases in liabilities such as future obligations for payment of pension benefits that were incurred as a result of current period employment.

Reporting these accrued transactions helps users of financial statements determine whether current-year revenues are sufficient to pay for current-year services.

Statement of Activities

Figure 1 illustrates the new Statement of Activities for state and local government reporting that will enable the reader to better assess the financial performance of the governmental unit. This new financial statement for governmentwide reporting will be implemented in three phases:

1. Fiscal periods beginning after June 15, 2001 for governments with annual revenues of \$100 million or more;
2. Fiscal periods beginning after June 15, 2002 for governments with annual revenues between \$10 million and \$100 million; and
3. Fiscal periods beginning after June 15, 2003 for governments with annual revenues of less than \$10 million.

The new Statement of Activities is intended to enable users to answer questions such as the following:³

- What do public services, such as public safety or recreation, really cost?
- How much of that cost is borne by today's taxpayers through general tax revenues?
- How much of the cost of current services is shifted to future generations of taxpayers?

Since the Statement of Activities is prepared using a long-term economic resource focus and the full-accrual basis of accounting, it can be used to determine the full cost of particular programs or functions. By analyzing net (expense) revenue for each program/function, the user can determine which programs are self-supporting and which ones are being subsidized by general revenues.⁴ "New information will be presented about the cost of programs, such as general government, public safety, public works, health and welfare, and parks and recreation. A greater understanding of the net cost of programs and activities that are subsidized by general tax revenues can be particularly helpful in deciding which programs should be privatized if governments downsize. Citizens can become more active participants in these resource allocation decisions."⁵

To illustrate, let's examine Figure 1. The Water and Sewer business-type activity shows net revenues (revenues exceed expenses) of \$4,466,000. Consequently, this activity would require no additional general revenues to subsidize its operations. On the other hand, the Parking business-type activity shows net expenses (expenses exceed revenues) of \$1,452,000 and therefore, would require general revenues to support its level of operations. The Public Safety government activity in Figure 1 shows net expenses of \$32,275,000 and would require a large proportion of the general revenues to finance its operations. For all of the governmental and business-type activities presented in Figure 1, the example city reports net expenses of \$49,079,000. The general revenue property and franchise taxes of \$60,484,000 adequately cover this amount. Therefore, it appears that there is a positive interperiod equity.

Currently, there are no agreed-upon metrics or ratios for measuring the extent to which interperiod equity has been achieved. Measurement of the financial performance of governmental entities on an accrual basis is continuing to evolve and modifications to reported financial data may be called for. One modification that is especially needed is when a governmental unit is comparing the change in interperiod equity over a multiple-year time frame. In order to make a valid comparison, adjustments for changes in current value (replacement cost) and general price-level changes (inflation) probably should be made to the reported financial data. For example, the dollar amounts expensed for public safety each year should be adjusted for the change in the purchasing power of the dollar. As a result, each year's expenditures would be based on a common unit of measure and, therefore, can be meaningfully compared.

Government Financial Managers Must Take the Lead

All user groups (including government managers) will find that measuring interperiod equity is important because it will enable them to use the Statement of Activities to:

- demonstrate operational accountability
- aid in setting priorities
- evaluate delivery of services
- assess the capability to continue or expand various services
- provide a basis for determining which programs should be contracted-out.

The "net program expense" format of the Statement of Activities emphasizes program-level accountability. This should provide "more accountability at deeper levels in the organizational structure."⁶ Consequently, managers of all programs and functions, whether that be the local library or the fire department, will find that they and their programs will be subject to greater scrutiny due to the more transparent financial reporting required by GASB.