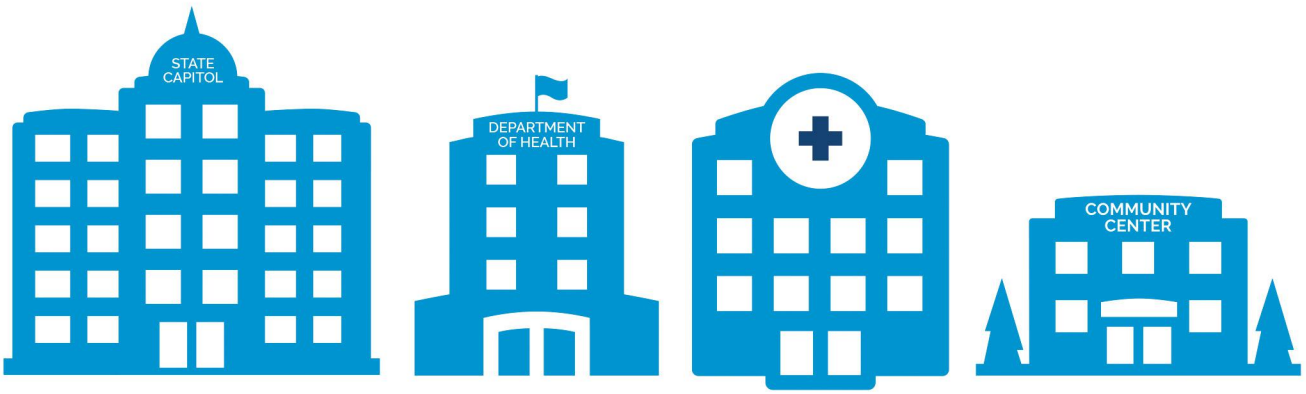
Seventh Edition

FINANCIAL MANAGEMENT

for Public, Health, and Not-for-Profit Organizations



Steven A. Finkler / Thad D. Calabrese / Daniel L. Smith

FINANCIAL MANAGEMENT FOR PUBLIC, HEALTH, AND NOT-FOR-PROFIT ORGANIZATIONS

Seventh Edition

Dedications

Steven A. Finkler
To Max, Livi, Judah, and Josie

Thad D. Calabrese
To Abby, Benjamin, Noah, and Ethan

Daniel L. Smith
To Tara, Madison, and Hudson

Sara Miller McCune founded SAGE Publishing in 1965 to support the dissemination of usable knowledge and educate a global community. SAGE publishes more than 1000 journals and over 800 new books each year, spanning a wide range of subject areas. Our growing selection of library products includes archives, data, case studies and video. SAGE remains majority owned by our founder and after her lifetime will become owned by a charitable trust that secures the company's continued independence.

Los Angeles | London | New Delhi | Singapore | Washington DC | Melbourne

FINANCIAL MANAGEMENT FOR PUBLIC, HEALTH, AND NOT-FOR-PROFIT ORGANIZATIONS

Seventh Edition

Steven A. Finkler
New York University
Thad D. Calabrese
New York University
Daniel L. Smith
University of Delaware

SAGE | CQPRESS

FOR INFORMATION:

CQ Press
An Imprint of SAGE Publications, Inc.
2455 Teller Road
Thousand Oaks, California 91320
E-mail: order@sagepub.com

SAGE Publications Ltd.
1 Oliver's Yard
55 City Road
London, EC1Y 1SP
United Kingdom

SAGE Publications India Pvt. Ltd.
B 1/I 1 Mohan Cooperative Industrial Area
Mathura Road, New Delhi 110 044
India

SAGE Publications Asia-Pacific Pte. Ltd.
18 Cross Street #10-10/11/12
China Square Central
Singapore 048423

Printed in the United States of America

Library of Congress Cataloging-in-Publication Data

This book is printed on acid-free paper.

Sponsoring Editor: Anna Villarruel
Production Editor: Rebecca Lee
Typesetter: Hurix Digital
Proofreaders: Eleni Maria Georgiou, Scott Oney
Indexer: Integra
Cover Designer: Scott Van Atta
Marketing Manager: Jennifer Haldeman

22 23 24 25 26 10 9 8 7 6 5 4 3 2 1

Brief Contents

PART IV REPORTING RESULTS

PART V FINANCIAL ANALYSIS

Detailed Contents

PART III IMPLEMENTATION AND CONTROLLING RESULTS

PART IV REPORTING RESULTS

Preface

To effectively administer and steward organizations serving the public, managers and policy makers must have a working knowledge of financial management to ensure organization missions are met while not sacrificing long-term survival. This does not mean that all managers and policy makers of government, not-for-profit, and health-care organizations must be financial managers or experts. However, they cannot simply rely on others to be aware of the financial issues that may be of concern to the organization, nor can today's managers depend solely on others to make consequential financial decisions. All managers must be able to understand and make use of financial information. This is particularly true at a time when mergers are increasingly common in the not-for-profit and health sectors—every merger requires, at a minimum, that managers read numerous documents with financial data.

This book provides a foundation in financial management to allow people to understand and use financial information. The intent of the book is not to make the reader an accountant. Rather, its goal is to provide enough of the language and tools of financial management to make the reader conversant in the field and a competent entry-level financial analyst in the public, health, or not-for-profit sector. The primary goal is to provide the skills necessary to use financial information. However, the text also provides technical skills needed to generate that information. In addition, the book strives to provide the foundation for additional coursework in such areas as debt financing, government budgeting and accounting, and health or not-for-profit management.

One of the skills that all users of financial information must have is a strong financial vocabulary. The fields of accounting, finance, and public finance are heavily laden with jargon. Any accountant can bury a non-accountant in debits and credits, journals, and reversing entries. A major emphasis of this book is on providing a working vocabulary for communication so that the reader can develop the ability to ask the right questions and interpret the answers.

In addition to vocabulary, this book describes a wide variety of methods, processes, and tools of accounting and finance. The book does not describe them in sufficient detail for the reader to fire the treasurer and controller and take over their jobs. (How many of you really want to do that?) Instead, there is sufficient detail so that the reader can comfortably use the wide variety of financial reports that are generated in the typical organization. Also, the user of this book will have an awareness of the techniques available that can provide information to help improve decision making.

The focus of the book is on the financial management of government, health, and not-for-profit organizations. Most financial books are oriented toward the for-profit corporate sector. Historically, they have had a heavy emphasis on manufacturing or financial markets. Recently, as the service sector of society has grown, there has been some shift in financial management toward service industries. However, government, health, and not-for-profit organizations are not typical service industries. The public sector that these organizations represent has developed its own financial management style and rules. Unusual public sector accounting approaches, such as fund accounting, heighten the challenge of studying financial management. As a result, it is vitally important to have a targeted book such as this one.

Some users of this book will indeed want to go farther in the field of financial management and gain a specialized knowledge. They will need to be able not only to use, but also to generate financial information. Some of the more technical aspects needed by those individuals are contained in the appendices to a number of the chapters in the book.

It is our hope and belief that this book fills a void in a number of ways. First, a substantial effort has been made to present all the material the target audience needs, while not including excess material that would obfuscate more than it would clarify. It is difficult to achieve the balance of being sufficiently inclusive to adequately cover the topic and yet not so inclusive as to overwhelm the reader. It is a balance that we have devoted substantial efforts to achieve.

Second, the book has been written with an awareness that there is considerable movement of managers among the three sectors covered in this book. "Public service" is a broad concept. Often people who enter public service find that their careers take unexpected twists and turns, moving from one part of the public sector to another. By providing information on government, health, and not-for-profit organizations, this book provides the user with the background needed for future opportunities in public service careers that may yet be beyond the reader's imagination.

Third, this book presents the order of material in a revolutionary way. Historically, accounting education has predominantly been targeted to those going into public accounting with the primary goal of becoming certified public accountants. As such, the elements of accounting most necessary for public accountants are taught first. Financial accounting, an area primarily involving the generation of information to be reported to people outside the organization, is generally taught before any of the elements of managerial accounting. However, most readers of this text will be managers rather than auditors. Their needs are oriented toward getting and using financial information to make decisions and manage effectively. Most managers will be exposed to budgets long before they see their organization's audited financial statements. Therefore, the book reverses the normal order of most financial management texts, providing the foundation of managerial accounting before the discussion of financial accounting.

The order in which the material is presented in this book is unique yet logical. The process of developing a plan for the future, implementing the plan, controlling operations to keep to the plan, reporting results, analyzing results, and using that information to improve future plans is the normal flow of financial information within an organization. It is the way that most managers deal with financial information. In using this book in the classroom, it has become apparent that this flow also helps readers get a better grasp of the entire financial management process.

The book is organized as follows: Chapter 1 provides an introduction and overview of financial management. The chapter also provides background information on the primary sources and uses of money in the public sector. The text then moves on to the organization's mission and the planning process in Chapters 2 through 6. A variety of budgeting techniques are discussed, and special attention is given to planning and measuring costs. Once made, plans must be implemented, with an effort to run the organization efficiently and to achieve its goals. Therefore, implementation and control issues are discussed in Chapters 7 and 8. These chapters focus on the management of short-term resources and obligations, and on issues of accountability and control. Managers need feedback to measure whether actual results are varying from the plan so that midstream corrections can be implemented. This feedback, in the form of variance reports, is also discussed in Chapter 8. At year-end the organization needs to aggregate the events of the year and prepare a report of what has transpired. This report contains a set of financial statements, which are discussed in Chapters 9 and 10. Special reporting concerns of health, not-for-profit, and governmental organizations are addressed in Chapters 11, 12, and 13. Finally, managers must analyze these results to understand the organization's financial position and performance. Financial statement analysis and financial condition analysis are covered in Chapters 14 and 15. A glossary is provided at the end of the book so that the reader can quickly access definitions of key terms used throughout the text, or terms that may be important in financial management in general.

NEW IN THIS SEVENTH EDITION

This seventh edition of *Financial Management for Public, Health, and Not-for-Profit Organizations* continues the work of the team of Steve Finkler, Thad Calabrese, and Dan Smith. Since the last edition was published, both the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB) have implemented significant changes to the treatment of important concepts and reporting. As such, the primary focus of the changes in this edition is on the material presented in the second half of the text.

Instructors using this text are reminded that they have access to case studies in both managerial and financial accounting online at https://edge.sagepub.com/finkler7e. The authors have updated these cases to reflect the changes presented in the seventh edition of the text. Faculty using this book who have developed their own cases over the years are encouraged to send them to us for possible inclusion with attribution in subsequent editions of the book (see our email addresses at the end of this preface).

One of the most important changes since the sixth edition relates to the Financial Accounting Standards Board's (FASB) Accounting Standards Codification 606 - Revenue from Contracts with Customers, commonly referred to as Topic 606. Under Topic 606, discounts are considered to be explicit price concessions, and are excluded from revenue. Further uncollectible amounts that can be anticipated are referred to as implicit price concessions and are also excluded from revenues. Bad debt expense now only is used for uncollectible amounts that could not have been anticipated and estimated.

Chapter 1 has been updated. We have added a new appendix to Chapter 4 to detail how to use Excel's Goal Seek function to analyze breakeven data. Our hope is that students and instructors will find this addition increases the use of spreadsheets in teaching and learning managerial accounting topics. To further emphasize the use of Excel over financial calculators, we switched the two appendices in Chapter 5 that detail their uses.

In Chapter 10, we have updated the text to reflect the adoption of FASB ASU No. 2014-09 related to revenue recognition. The sixth edition included language that reflected the original standards because the new standards were still in the process of implementation; this seventh edition, by contrast, fully reflects current FASB standards. In Chapter 10 we also discuss the new FASB Topic 606. In addition, the financial statements that illustrate topics in Chapters 9 and 10 now reflect the changes resulting from recent FASB changes.

Chapter 11, which examines unique accounting issues for not-for-profit and health-care organizations, no longer distinguishes between voluntary health and welfare organizations and other not-for-profits, primarily because the accounting treatment of not-for-profits is moving toward homogeneity. The chapter now emphasizes the similarity of not-for-profit financial accounting regardless of the type of not-for-profit organization.

In addition, the chapter no longer focuses on donated services as in prior editions. FASB ASU 2020-07 was issued to clarify how not-for-profits should account for the contribution of nonfinancial assets such as capital assets, donated supplies, and contributed services. Chapter 11 now discusses donated services in light of this updated change in accounting.

The financial statement analysis in Chapter 14 incorporates these FASB changes. Also, we have changed the name of the organization so that it is differentiated from a similarly named organization used in earlier chapters. This decision was made simply to make clear where prior examples began and ended.

Governmental accounting standards have continued to evolve since the sixth edition of the book was published. Chapter 12 now begins by introducing the new GASB term for governmental financial reports: the Annual Comprehensive Financial Report (ACFR). It also highlights that governments still use the traditional treatment of accounting for bad debts,

which Topic 606 changed for private organizations. Further, while GASB has changed and implemented several new standards, we have chosen to edit the existing chapters largely to minimize changes to textbook users. Chapter 15 updates the sources of data for analyzing the financial condition of governments.

In addition to the above, minor clarifications and general updates have been made for all chapters throughout the book. Homework problems at the end of each chapter have been updated and expanded. The resources available online for instructors, including Homework Excel Templates, Homework Solutions, PowerPoint slides, and Test Bank problems, have all been revised, updated, and expanded. We have used embedded Excel objects in the solutions files and PowerPoint class notes to make it easier for students and instructors to review the calculations and examine the impact of changes in any of the variables.

This new edition is accompanied by materials on the Web. Instructor resources are available at https://edge.sagepub.com/finkler7e. The online materials include

- Word document solutions to all assignment material;
- Excel templates for selected homework problems (These may be made available to students at faculty discretion; however, they may not be posted on open-access internet sites accessible to those outside your class.);
- Excel solutions to selected homework problems; and
- Case Studies and expanded PowerPoint class notes.

We very much appreciate the feedback we have received directly from you—our students, colleagues, and friends. This book was a major undertaking. The results were substantially improved by the valuable comments and suggestions made by our colleagues and students. We offer our thanks to our many colleagues around the country who reviewed the manuscript for this and earlier editions and made important suggestions, including Khaled Amin, Emily Crawford, Tim Ettenheim, Santa Falcone, Dall Forsythe, Francesca Frosini, Patrice Iatarola, Dick Netzer, Pam Ouellette, Yousuf Rahman, Mark Robbins, Shanna Rose, Amy Schwartz, Bill Voorhees, and Robert Winthrop and Anubhav Gupta. We are grateful to David Strungis, who reviewed all the problems and solutions for the fourth edition, as well as Laura Hoguet, who reviewed all the assignment material for the second edition. Special thanks go to Dwight Denison, Marty Ives, Bernard Jump Jr., Ken Kriz, Dean Mead, William Moore, Ross Rubenstein, and Leanna Stiefel, whose efforts went beyond the call of duty. We would also like to thank the publisher's reviewers, whose comments led to a number of improvements:

Anubhav Gupta, National University of Singapore;
Robert Bartolacci, CarnMellon University (2nd Edition);
James Caillier, University of Alabama (4th Edition);
Thomas Carment, Rogers State University (4th Edition);
Gang Chen, University at Albany-SUNY (6th Edition);
Susan Convery, Michigan State University (4th Edition);
Tom Courtney (1st Edition);
Thomas Crothers, Western Michigan University (6th Edition);
Stan Davis, Indiana University–Purdue University Fort Wayne (1st Edition);
Rev. Albert J. DiUlio, The Vatican Observatory (1st Edition);
Harwell Herring III, Utica College (2nd Edition);
Chaman L. Jain, St. John's University (3rd Edition);

Lara Khouri, Columbia University (4th Edition);
Kimberly Kopka, Eastern Michigan University (5th Edition);
Kenneth Kriz, University of Illinois Springfield (6th Edition);
Karen Kunz, West Virginia University (5th Edition);
James Lock, Northern Virginia Community College (4th Edition);
David Matkin, BYU (4th and 6th Editions);
Jose Mercado, CUNY - Baruch College (5th Edition);
Melissa Merrell, Congressional Budget Office (4th Edition);
Boris Morozov, Lock Haven University (4th Edition);
Daniel Gordon Neely, University of Wisconsin-Milwaukee (6th Edition);
Laura Peck, Abt Associates (2nd Edition);
Chester A. Robinson, Jackson State University (5th Edition);
Ross Rubenstein, Georgia State University (4th and 5th Editions);
Jay Ryu, Ohio University (4th and 5th Editions);
Randy Serrett, University of Houston-Downtown (4th Edition);
H. "Charlie" Sparks, University of Alaska (4th Edition);
Megan Streams, Tennessee State University (4th Edition);
William Zelman, University of North Carolina (1st Edition).

Bernard (Bunny) Jump Jr. of the Maxwell School gets the medal of valor for having used the earliest drafts of the first edition of this book with his classes before even the most obvious and significant errors were removed. His tenacity in going through a number of different drafts of the book and his conceptual and technical comments throughout the process were invaluable. It is with great sadness that we note the passing of Bunny on August 21, 2019, at the age of 81. Bunny served The Maxwell School for over three decades as faculty member, chair of the Department of Public Administration and in many other leadership roles.

Ken Milani has been particularly generous in both reviewing our text over numerous editions, and also allowing us to include material he authored on budgeting as well as on the unrelated business tax. Our thanks also go to Robert Purtell, Dwight Denison, Drew Franklin, Santiago Guerrero, Ed Roche, Khaled Amin, and Louis Stewart for specific valuable contributions to the book. Louis Stewart passed on September 19th, 2012, at the age of 60. He was a good colleague and friend to the lead author of this text. Robert Purtell coauthored the fifth edition with us and contributed many of the homework problems and case studies that appear in the online resources. Dwight Denison authored a number of homework problems that appear at the end of chapters throughout the book as well as the Ponderosa case study, which appears in the online resources.

We would like to thank the entire CQ Press team for their remarkable job in getting this book to the reader. We thank our acquisitions editor, Anna Villarruel, for overseeing the entire project. Production editor Rebecca Lee managed the production process, and Eleni Maria Georgiou and Scott Oney did a fantastic job proofreading the manuscript.

Any errors that remain are our responsibility. We welcome all comments and suggestions. Please feel free to contact either Dan Smith or Thad Calabrese by email.

Steven A. Finkler, PhD, CPA
Professor Emeritus of Public and Health Administration, Accounting, and Financial Management
The Robert F. Wagner Graduate School of Public Service
New York University
New York, NY

Thad D. Calabrese, PhD
Associate Professor of Public and Nonprofit Financial Management
The Robert F. Wagner Graduate School of Public Service
New York University
New York, NY
thad.calabrese@nyu.edu

Daniel L. Smith, PhD
Associate Dean, College of Arts & Sciences
Associate Professor, Joseph R. Biden, Jr. School of Public Policy & Administration
University of Delaware
Newark, DE
dansmith@udel.edu

Case Examples

Throughout this text there are running case examples regarding the town of Millbridge, the Hospital for Ordinary Surgery, Meals for the Homeless, and Save the Children. These organizations and their managers are fictitious, and any similarity to any real organization or person is strictly coincidental.

About the Authors

Steven A. Finkler

Dr. Steven A. Finkler is Professor Emeritus of Public and Health Administration, Accounting, and Financial Management at New York University's Robert F. Wagner Graduate School of Public Service (NYU Wagner). At NYU Wagner he headed the specialization in health services financial management for more than 20 years. Dr. Finkler is an award-winning teacher, author, and researcher.

Among his publications are 31 books, including *Financial Management for Nurse Managers and Executives*, 5th ed. (with Cheryl Jones and Christine T. Kovner, 2018); *Accounting Fundamentals for Health Care Management*, 3rd ed. (with Thad Calabrese and David Ward, 2019); and *Finance and Accounting for Nonfinancial Managers*, 5th ed. (2017). He has also published more than 200 articles in many journals, including *Health Services Research, Journal of Public Policy and Management,* and *Healthcare Financial Management*.

He received a bachelor of science degree in economics (dual major in accounting and finance), and a master of science degree in accounting from the Wharton School at the University of Pennsylvania, and a master of science degree in economics and doctorate in business administration at Stanford University.

Dr. Finkler, who is also a certified public accountant, worked as an auditor with EY (formerly known as Ernst and Young) and was on the faculty of the Wharton School before joining NYU. He is a past member of the executive board of the International Society for Research in Healthcare Financial Management and the editorial board of *Health Care Management Review*, and he served as treasurer and a member of the board of governors of the Daughters of Israel Geriatric Center. He was the editor of *Hospital Cost Management & Accounting* for 12 years and is a past member of the National Advisory Council for Nursing Research at the National Institutes of Health. He consults extensively, both around the country and abroad.

Thad D. Calabrese

Thad D. Calabrese, PhD, is associate professor of public and nonprofit financial management at NYU Wagner, and is director of the school's finance specialization. His research focuses on not-for-profit and government accounting and finance and is published in the *Journal of Public Administration Research and Theory, Public Administration Review, Public Budgeting & Finance, Journal of Accounting and Public Policy, Nonprofit and Voluntary Sector Quarterly, National Tax Journal, Public Finance Review,* and *Nonprofit Management & Leadership (NML)*, among others. In addition, he has served in several member-elected positions, including Chair of the Association for Budgeting and Financial Management and Treasurer for the Association for Research on Nonprofit Organizations and Voluntary Action. He currently serves on the Governmental Accounting Standards Advisory Council. Prior to entering academia, he worked as a financial manager in the not-for-profit sector and in local government.

Daniel L. Smith

Daniel L. Smith, PhD, is Associate Dean for the Social Sciences in the College of Arts & Sciences and Associate Professor in the Biden School at the University of Delaware. His research focuses on state government budgeting and financial management and appears in *Journal of Policy Analysis and Management, Journal of Public Administration Research and Theory (JPART), Public Administration Review (PAR), Public Budgeting & Finance*, and *Public Choice*, among others. In addition, he has been coeditor of *JPART* and has served on *PAR*'s editorial board. Dr. Smith is a past chair of the Association for Budgeting and Financial Management and a former member of the Governmental Accounting Standards Advisory Council. He is a current member of the Commission on Peer Review and Accreditation (COPRA). He earned his doctorate in public administration in the School of Public and International Affairs at the University of Georgia.

Introduction: Setting the Stage

Introduction to Financial Management

This book is written for current and future public service managers and policy makers. Each person working in such a capacity—in government, in health care, or in a not-for-profit organization—will need to generate and/or use financial information. Some will become financial specialists and will use this book as their introduction to the field. For many readers, however, this book may be their only formal exposure to the concepts of financial management.

By the end of this book, the reader should be comfortable with the basics of financial management. That means the reader should be able to prepare and analyze budgets and financial statements, read and interpret financial information, and perform financial analyses. The reader should also have an appreciation for some of the things that financial management can do and know when to call on a financial expert. Most importantly, the reader should have an improved ability to use financial information in making managerial and policy decisions.

Even those who do not expect their careers to focus primarily on financial issues will find that an understanding of basic financial concepts is essential. All organizations are dependent on obtaining adequate financial resources and putting them to their best use. Resources are scarce, and financial management provides information about how scarce those resources will be and how they will be or have been used. Financial management gives managers tools that will aid them in achieving both the broad and the specific goals of the organization.

This chapter begins with an overview of financial management. The chapter next moves on to examine public sector resource flows. From where does each of the major public service sectors get its resources, and on what does it spend those resources? The chapter then addresses the question of why government, health-care, and not-for-profit organizations are all included in this one text.

The discussion next turns to whether such organizations should earn a profit from their activities. This gives rise to consideration of the tax implications if a public sector organization

LEARNING OBJECTIVES

The learning objectives of this chapter are to:

- define financial management;
- define accounting and finance;
- discuss the sources and uses of resources in the public sector, including the federal government, state and local governments, health-care organizations, and not-for-profit organizations;
- explain why public service organizations should be concerned with financial management;
- explain why public service organizations should earn profits; and
- introduce a hypothetical ongoing example to be used throughout the text.

does earn a profit. The chapter concludes with the introduction of a hypothetical example that will be used throughout the text.

In this and every chapter, a great deal of new vocabulary is introduced. The first time a new term appears in the text, it is shown in bold. Words in bold are listed in the Key Terms section at the end of each chapter. These words are defined in the glossary at the end of the book.

WHAT IS FINANCIAL MANAGEMENT?

Financial management is the subset of management that focuses on generating financial information that can be used to improve decision making. In **proprietary,** or for-profit, organizations, the unifying goal of all decisions is to maximize the wealth of the owners of the organization. In public service organizations—the term by which we may collectively refer to public, health, and not-for-profit organizations—the decisions are oriented toward achieving the various goals of the organization while maintaining a satisfactory financial situation. Financial management encompasses the broad areas of **accounting** and **finance**.

Accounting is a system for keeping track of the financial status of an organization and the financial results of its activities. It is often referred to as the language of business. The vocabulary used by accounting is the language of nonbusiness organizations as well. Governments, health-care organizations, and not-for-profit organizations often do not see themselves as being "in business." Yet they must deal with many of the same financial issues as other types of organizations or risk "going out of business." **Receivables**, **payables**, **inventory**, **net assets**, **depreciation**, and **debt** are just a few of the accounting terms that managers of public service organizations encounter in their interactions with the organization's financial managers. These terms, and many others, will be introduced and explained throughout the book.

Accounting is subdivided into two major areas: **managerial accounting** and **financial accounting**. Managerial accounting relates to generating any financial information that managers can use to improve the future results of the organization. This includes techniques designed to generate any financial data that might help managers make more-effective decisions. Major aspects of managerial accounting include making financial plans for the organization, implementing those plans, and then working to ensure that the plans are achieved. Some examples of managerial accounting include preparing annual operating budgets, generating information for use in making major investment decisions, and providing the data needed to decide whether to buy or lease a major piece of equipment.

Financial accounting provides retrospective information. As events that have financial implications occur, they are recorded by the financial accounting system. From time to time (usually monthly, quarterly, or annually), the recorded data are summarized and reported to interested users. The users include both internal managers and people outside the organization. Those outsiders include those who have lent or might lend money to the organization (**creditors**), those who might sell things to the organization (suppliers or **vendors**), those who might seek the organization's services (e.g., clients or patients), and other interested parties. These interested parties may include regulators, legislators, and citizens. Financial statements provide information on the financial status of the organization at a specific point in time, in addition to reporting the past results of the organization's operations (i.e., how well it has done from a financial perspective).

Finance focuses on the alternative sources and uses of the organization's financial resources. Obtaining funds when needed from appropriate sources and the deployment of resources within the organization fall under this heading. In addition, finance involves the financial markets (such as stock and bond markets) that provide a means to generating funds for organizations. Chapters 5, 6, and 7 discuss finance as it relates to public service organizations.

PUBLIC SECTOR RESOURCE FLOWS

The public, health, and not-for-profit sectors in the United States are large. Federal government receipts were over $3.4 trillion in the fiscal year 2020.[1] In addition, state and local government receipts exceed $3.3 trillion annually.[2] Spending on health care, meanwhile, now exceeds $3.8 trillion each year and is expected to pass $5.2 trillion by 2025.[3] Finally, not-for-profit organizations reported a total of $2.6 trillion in revenue as of 2016, the most recent year for which data are available.[4] Public service organizations obtain their financing from a variety of sources. The focus here will be on the major sources and uses of money in the public sector.

Governments

THE FEDERAL GOVERNMENT The federal government represents a major component of the entire American economy. Where does the federal government get all its money, and how does it spend it? Table 1-1 provides a summary of the inflows to the federal government. Many organizations choose a year-end for accounting purposes that differs from the calendar year. The reasons for such a choice are discussed later in this book. Such years are referred to as **fiscal** years. The federal 2023 fiscal year begins on October 1, 2022, and ends on September 30, 2023.

TABLE 1-1 Federal Receipts for the Fiscal Year Ending September 30, 2019 and 2020* (in Billions, On- and Off-budget)

Receipts	2019	2020
Individual Income Taxes	$1,718	$1,609
Social Insurance Taxes	1,243	1,310
Corporation Income Taxes	230	212
Other	273	290
Total	$3,464	$3,421

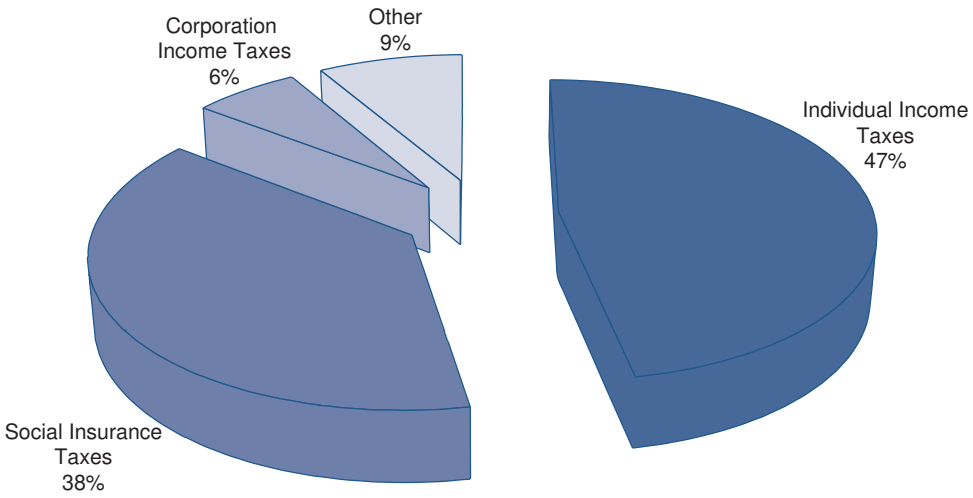
* 2020 values are estimates.
Source: Abstracted from "Table B–47, Federal receipts and outlays, by major category, and surplus or deficit, fiscal years 1955–2020," *The Economic Report of the President, 2021* (Washington, D.C.: United States Government Printing Office, 2021), 512.

Several types of receipts make up the bulk of federal government collections. These are individual income taxes, social insurance taxes (the majority of which are Social Security taxes), and corporation income taxes. Notice in Table 1-1, that individual income taxes declined in 2020. This was the first decline since 2010, which was the tail end of the Great Recession of 2008. Corporate income taxes also declined in 2020. These declines are the first indications of

[1] "Table B-47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1955–2020," *The Economic Report of the President*, 2021 (Washington, DC: United States Government Publishing Office, 2021), 512.
[2] "Table B-50, State and Local Government Revenues and Expenditures, Fiscal Years 1956–2018," *The Economic Report of the President*, 2021 (Washington, DC: United States Government Publishing Office, 2021), 515.
[3] Centers for Medicare & Medicaid Services, Office of the Actuary. National Health Statistics, "Table 16: National Health Expenditure (NHE), Amounts and Average Annual Growth From Previous Years Shown, By Type of Sponsor, Selected Calendar Years 2012–2028." https://www.cms.gov/research-statistics-data-and-systems/statistics-trends-and-reports/nationalhealthexpenddata.
[4] NCCS Project Team, *The Nonprofit Sector in Brief 2019* (The Urban Institute, National Center for Charitable Statistics, June 2020). https://nccs.urban.org/publication/nonprofit-sector-brief-2019#finances.

the impact of the COVID-19 pandemic of 2020-21 (COVID). We will see more impacts below. The relative proportions of the different categories of total federal receipts in 2020 can be seen in Figure 1-1. The "other" category in Figure 1-1 includes things such as taxes on cigarettes and liquor, estate (inheritance) and gift taxes, and customs duties (charges on imports).

FIGURE 1-1 Federal Receipts by Source (in Percentages) for the Fiscal Year Ending September 30, 2021 (Estimates)



Source: Derived from "Table B-47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1955–2020," *The Economic Report of the President, 2021* (Washington, DC: United States Government Publishing Office, 2021), 515.

During the second decade of this century, Social Security and national defense have been the largest federal outlay categories. However, in 2020 the income security and other categories leapt ahead of Social Security and national defense (see Table 1-2). The "other" category in Table 1-2 includes a wide variety of areas, such as education, the space program, agriculture, commerce, housing, transportation, and general government administration.

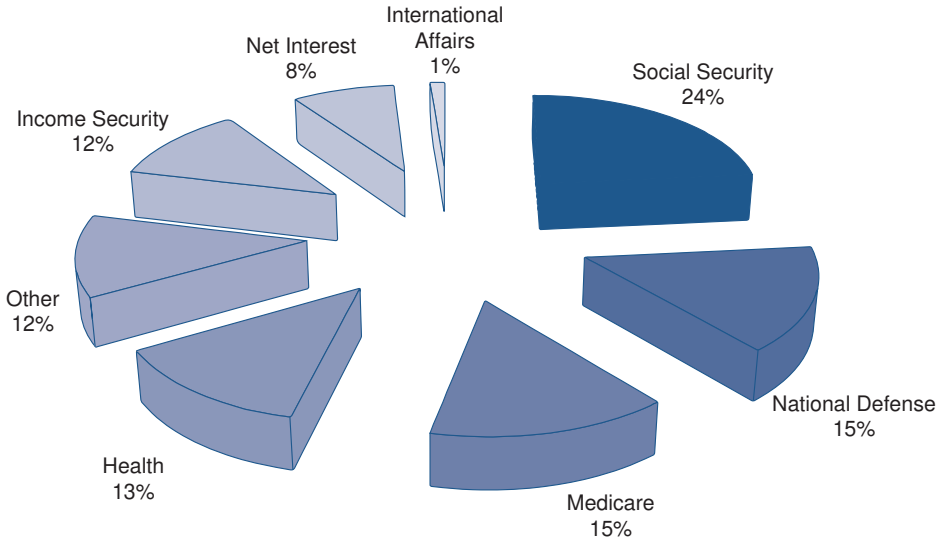
TABLE 1-2 Federal Outlays for the Fiscal Years Ending September 30, 2019 and 2020* (in Billions, On- and Off-budget)

Outlays	2019	2020
Income Security	$ 515	$1,263
Social Security	1,044	1,096
Medicare	651	776
Health	585	748
National Defense	686	726
Net Interest	375	345
International Affairs	53	68
Other	539	1,531
Total	$4,448	$6,553

* 2020 values are estimates.
Source: Abstracted from "Table B–47, Federal receipts and outlays, by major category, and surplus or deficit, fiscal years 1955–2020," *The Economic Report of the President, 2021* (Washington, D.C.: United States Government Printing Office, 2021), 512.

The sharp increases in 2020 on spending on income security, which includes direct payments and food supplements to low-income or temporarily economically distressed individuals, reflects the substantial government spending related to COVID. The federal government made significant stimulus payments to individuals and businesses, and also spent money on COVID testing, to acquire and administer vaccines, to provide protective gear and other medical supplies and equipment, and for other COVID-related costs. Total spending rose from $4.4 trillion in 2019 to $6.6 trillion in 2020 (see Table 1-2), a 33% increase in just one year. During the same period federal receipts remained nearly unchanged at $3.4 trillion (see Table 1-1).

FIGURE 1-2 Federal Outlays by Category (in Percentages) for the Fiscal Year Ending September 30, 2019



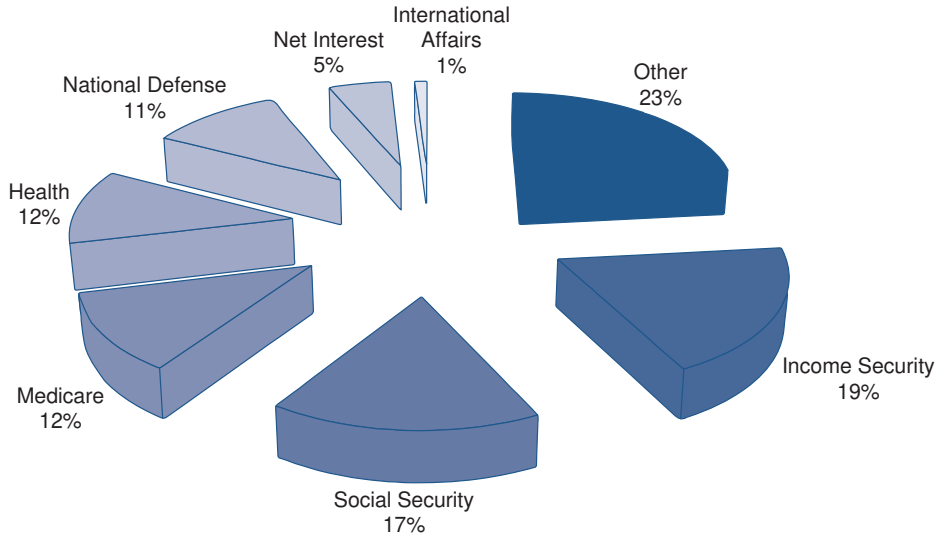
Source: Derived from "Table B-47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1955–2020," *The Economic Report of the President, 2021* (Washington, DC: United States Government Publishing Office, 2021), 515.

Prior to COVID, Social Security accounted for nearly a quarter of all federal outlays, making it the single largest category of spending by a wide margin (see Figure 1-2). National defense (15%), Medicare (15%), health care (13%), and income security (12%) also represented large shares of federal spending. Although COVID outlays by the federal government remained high in 2021, it is not unlikely that there will be a return to the trends of the previous decade in the years following 2021. However, this may be impacted by changes in federal government priorities. For example, if a sizable infrastructure bill were to become law. As the government responded to COVID, we can see dramatic shifts in Figure 1-3. Social Security spending, while higher in 2020 than 2019 in absolute terms (see Table 1-2), dropped to 17% of federal government spending, while the other category and income security surged to 23% and 19% of total spending.

Total spending on defense increased substantially in the years following the 9/11 attack in 2001 and then even more during the wars in Iraq and Afghanistan that followed. Since American combat troops have largely been withdrawn from those wars, however, defense spending has dramatically declined. As of this writing, the war in Afghanistan has officially concluded.

Medicare is a health insurance program for the elderly and permanently disabled. The "health" category includes Medicaid—health insurance for low-income individuals—and all other federal government spending on health-care services and research, aside from Medicare.

FIGURE 1-3 Federal Outlays by Category (in Percentages) for the Fiscal Year Ending September 30, 2020 (Estimates)



Source: Derived from "Table B-47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1955–2020," *The Economic Report of the President, 2021* (Washington, DC: United States Government Publishing Office, 2021), 515.

"Net interest" represents the amount the federal government pays in interest annually, primarily on the federal debt.

The total receipts in Table 1-1 are less than the outlays in Table 1-2. An excess of receipts over spending is referred to as a **surplus**. An excess of spending over receipts is referred to as a **deficit**. Table 1-3 provides information about federal receipts, outlays, surplus or deficit, and debt for selected fiscal years 1970 to 2020.

TABLE 1-3 Federal Receipts, Outlays, Surplus or Deficit, and Debt (in Billions)

	Fiscal Year Ending September 30						
	1970	1980	1990	2000	2010	2019	2020*
Total Receipts	$193	$517	$1,032	$2,025	$ 2,163	$ 3,464	$ 3,420
Total Outlays	196	591	1,253	1,789	3,457	4,448	6,552
Surplus or Deficit	$ (3)	$(74)	$ (221)	$ 236	$(1,294)	$ (984)	$(3,132)
Gross Federal Debt	$381	$909	$3,206	$5,629	$13,529	$22,670	$26,901

*Estimates

Source: Abstracted from "Table B–45, Federal receipts, outlays, surplus or deficit, and debt, fiscal years 1955-2020," *The Economic Report of the President, 2021* (Washington, D.C.: United States Government Printing Office, 2021), 510.

The receipts and outlays in Table 1-3 represent the total of **on-budget** and **off-budget** items. A large portion of the Social Security receipts and payments are considered off-budget. Off-budget items are those items that are not included in the normal federal government budget process. For example, Social Security taxes and payments are off-budget. Which number better represents the surplus or deficit for the federal government? That is difficult to say.[5] Based on

[5] See James Howard, "Government Economic Projections: A Comparison Between CBO and OMB Forecasts," *Public Budgeting and Finance* 7 (1987): 14–25.

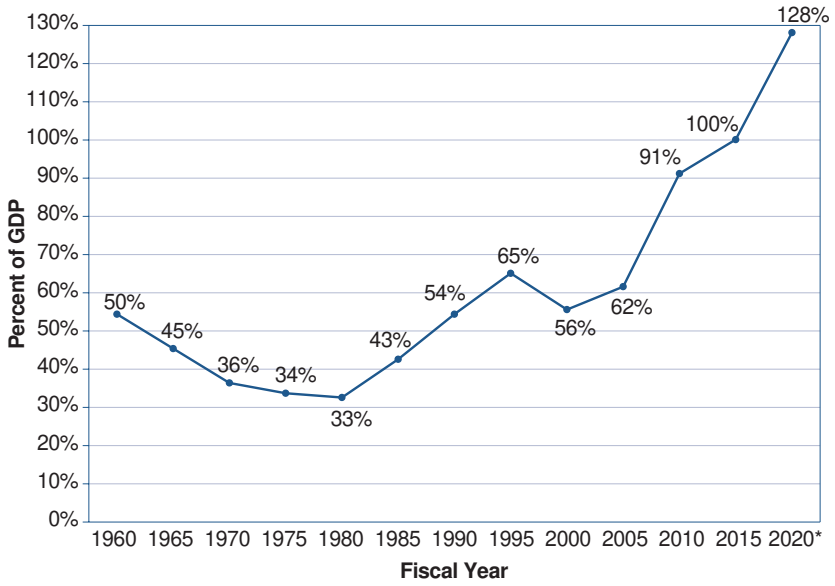
receipts and disbursements, one could argue that the total receipts and total outlays reported in Table 1-3 are reasonable. Others would argue that Social Security collections in excess of Social Security payments should not be used to offset general government spending. Those monies are collected with the expectation that they will be used only for Social Security payments.

Another concern is that the federal debt has grown large. The federal government's **national debt** (or **gross federal debt**) is the total cumulative amount that the federal government has borrowed and not yet repaid. Thus, a deficit shows the amount spent in 1 year in excess of receipts. The debt shows the accumulated amount that the government owes because spending over time has exceeded receipts.

If the federal government incurs deficits year after year—as it routinely has for decades—then the size of the debt will continue to grow. However, note in Table 1-3 that even during the period around 2000 when the federal government had surpluses, the total debt continued to grow! This is a result of the on-budget, off-budget accounting of the federal government. The surplus and deficits shown in Table 1-3 are on-budget and off-budget items combined. Off-budget surpluses are being used to offset on-budget spending. This allows the government to report a lower deficit or a higher surplus. However, when the federal government uses social insurance trust funds (off-budget money) to offset the deficit, it must borrow them from the Social Security trust fund, increasing the overall level of the national debt. In other words, the overall amount of federal debt does recognize that taxes raised currently for future Social Security payments create obligations to make future payments. However, the calculation of the annual federal surplus or deficit is based more on a cash-in, cash-out perspective. If the cash is available to the government and is spent, that does not create a deficit for the year, even if the cash was supposed to be used for some future purpose such as making Social Security payments down the road.

Following World War II, the gross federal debt reached a high of 120 percent of the gross domestic product (GDP). That percentage fell over the decades following the war and reached a low of 33 percent in 1980, as seen in Figure 1-4. However, since 1980 the debt has risen substantially

FIGURE 1-4 Federal Debt as a Percentage of GDP*



Note: *Estimate
Source: Derived from "Table B-46, Federal receipts, outlays, surplus or deficit and debt, as percent of gross domestic product, fiscal years 1949–2020," *The Economic Report of the President, 2021* (Washington, DC: United States Government Publishing Office, 2021), 511.

TABLE 1-4 Federal Debt and Gross Domestic Product—Selected Fiscal Years (Billions of Dollars)

	Fiscal Year Ending September 30							
	1960	1970	1980	1990	2000	2010	2019	2020*
Gross Federal Debt	291	381	909	3,206	5,629	13,529	22,670	26,901
Gross Domestic Product (GDP)	534	1,047	2,792	5,899	10,117	14,839	21,224	20,996

*Estimates

Source: Abstracted from "Table B–45, Federal receipts, outlays, surplus or deficit, and debt, fiscal years 1955–2020," *The Economic Report of the President, 2021* (Washington, D.C.: United States Government Printing Office, 2021), 510.

compared to the total US economy as measured by the GDP, with the only exception being around 2000, when the on- and off-budget accounts were in surplus (see Table 1-4 and Figure 1-4). The debt as a percent of GDP, estimated to be 128% for 2020, exceeds the previous all-time high.

Focusing on the period since 2000, there are several reasons the national debt has grown as a percentage of GDP. Both revenue and expenditure actions have played a role, in addition to external economic factors. The 2001 recession reduced tax revenues due to higher unemployment and lower corporate profits. Large tax cuts in 2001 and 2003, a post-9/11 expansion in homeland security operations, and new defense spending for wars in Afghanistan and Iraq all contributed to growth in the national debt, as did a major expansion of the Medicare program in 2006 (providing coverage for pharmaceuticals). In addition, countercyclical fiscal policies following the so-called Great Recession that spanned the end of 2007 through the middle of 2009—namely, direct government financial assistance to for-profit companies, investment in national infrastructure, a temporary cut in federal payroll taxes, and an extension to federal unemployment benefits—further exacerbated the nation's debt load.

Moreover, the Patient Protection and Affordable Care Act (ACA) of 2010 has contributed to the federal debt principally by expanding eligibility for the Medicaid program. The ACA was forecast to have been deficit-reducing due to an excise tax on high-cost private health insurance programs. That so-called Cadillac tax has not yet been implemented, however. Meanwhile, the most recent major revenue action by the federal government, the Tax Cuts and Jobs Act of 2017 (TCJA), substantially reduced corporate tax rates, and to a lesser extent individual tax rates. As above, the president and Congress also separately agreed to major increases in spending, especially on national defense. The increase to the national debt of the TCJA alone was forecast to be greater than $1 trillion, and new spending only adds to that.

The 2007–9 recession had an unusually severe impact on the federal government in that actual receipts for fiscal year 2009 were 22 percent lower than estimated in the 2008 edition of *The Economic Report of the President,* while outlays were more than 13 percent higher than estimated. High unemployment and stimulative tax cuts depressed individual and corporation income and payroll tax receipts, while stimulus spending, so-called bailouts of the for-profit sector, and expanding rolls for social insurance safety-net programs pushed outlays well beyond estimates. Several extensions made to unemployment insurance benefits payments were a particularly visible and hotly debated source of expenditure growth. Using the unemployment rate and the **federal funds rate**—the interest rate at which financial institutions lend each other reserves—as standard measures of general economic health, the 2007–9 recession's effects did not substantially recede until 2017.

The COVID-19 pandemic contributed to the deficits and debt in a dramatic way. The 28% rise of the debt as a percent of GDP in the five year period from 2015–2020 is only exceeded by the 29% rise from 2005–2010, during the Great Recession of 2008. But it should be noted that by 2019, before COVID, the debt had already risen to a level of 107% of GDP.

STATE AND LOCAL GOVERNMENTS What are the sources and uses of money at the state and local government levels? Sales, property, and income taxes are the major forms of taxation used by state and local governments, as shown in Table 1-5 and Figure 1-5. Clearly, however, another significant source of funds for state and local governments is the federal government. Other receipts include taxes on motor vehicles, various fees, other taxes, and miscellaneous revenues.

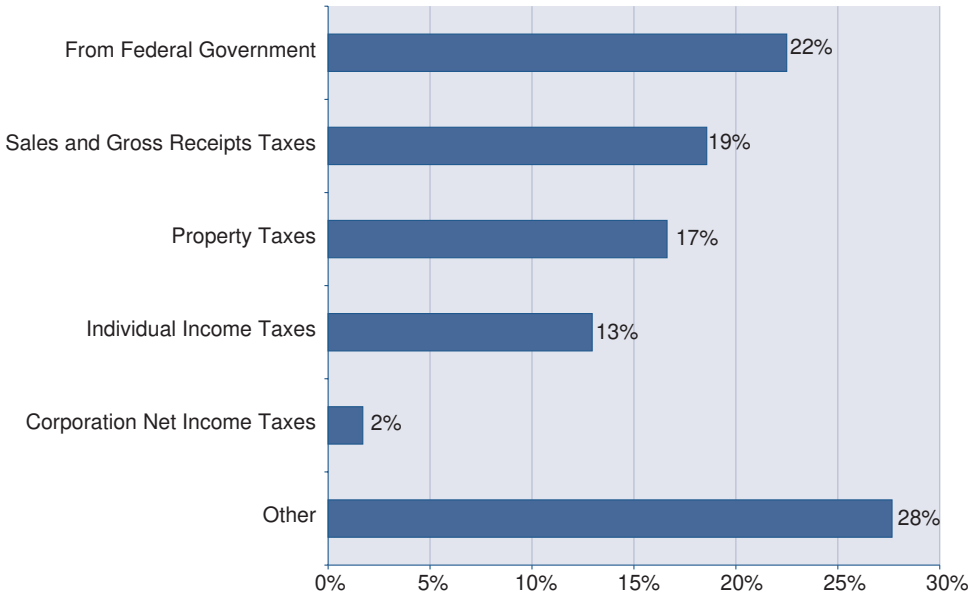
State and local governments rely on each of these sources to varying degrees, and not all state and local governments have the same mix. For example, local governments tend to rely heavily on property taxes, whereas state governments do not. Also, not all states have income taxes on individuals or on businesses, nor do all states have sales taxes.

TABLE 1-5 State and Local Government Receipts for the Fiscal Year Ending 2018 (in Billions)

Receipts	Amount
From Federal Government	$ 740
Sales and Gross Receipts Taxes	611
Property Taxes	547
Individual Income Taxes	426
Corporation Net Income Taxes	56
Other	910
Total	$3,290

Source: Abstracted from "Table B–50, State and local government revenues and expenditures, fiscal years 1956–2018," *The Economic Report of the President, 2021* (Washington, D.C.: United States Government Printing Office, 2021), 515.

FIGURE 1-5 State and Local Government Receipts for the Fiscal Year Ending 2018 (in Percentages)



Note: Percents do not add up to 100% due to rounding.
Source: Derived from "Table B-50, State and local government revenues and expenditures, fiscal years 1956–2018," *The Economic Report of the President, 2021* (Washington, DC: United States Government Publishing Office, 2021), 515.

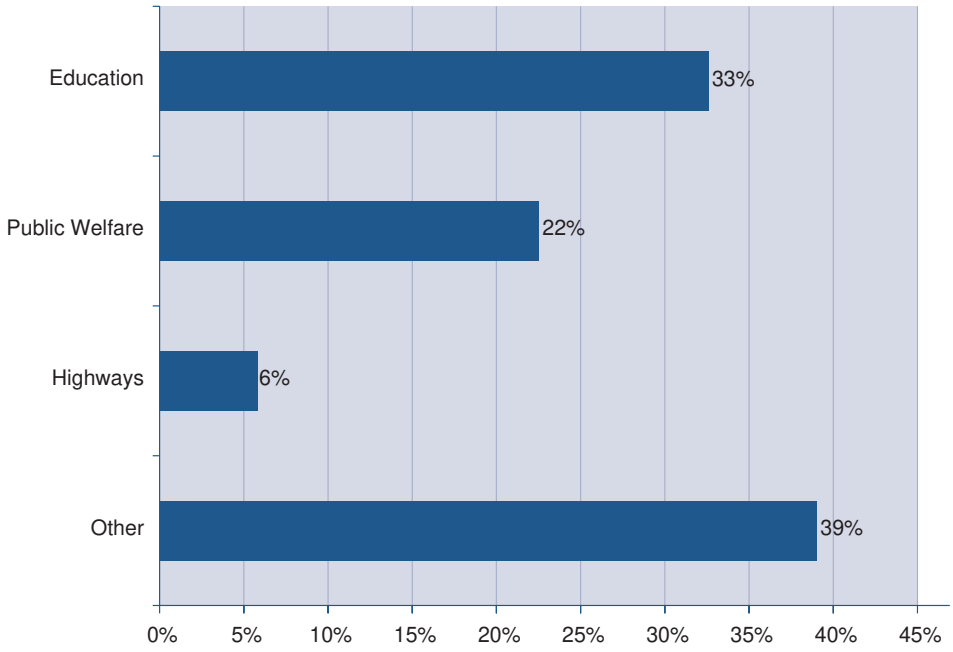
Table 1-6 and Figure 1-6 show how state and local governments use their resources. The single largest object of expenditure is education, representing 33 percent of state and local outlays. Public welfare and highways are other significant items for state and local governments. Note that 39 percent of spending is in the "other" category. This is a reflection of the tremendous diversity in the states and localities of the country. Some have high costs for snow removal and subway systems. Others have no snow and little public transit. Common types of costs included in the "other" category are libraries, police and fire protection, and parks.

TABLE 1-6 State and Local Government Outlays for the Fiscal Year Ending 2018 (in Billions)

Outlays	Amount
Education	$1,046
Public Welfare	721
Highways	187
Other	1,250
Total	$3,205

Note: Line items do not precisely sum to total due to rounding.
Source: Abstracted from "Table B–50, State and local government revenues and expenditures, fiscal years 1956–2018," *The Economic Report of the President, 2021* (Washington, D.C.: United States Government Printing Office, 2021), 515.

FIGURE 1-6 State and Local Government Outlays for the Fiscal Year Ending 2018 (in Percentages)



Source: Derived from "Table B-50, State and local government revenues and expenditures, fiscal years 1956–2018," *The Economic Report of the President, 2021* (Washington, DC: United States Government Publishing Office, 2021), 515.

The U.S. Census Bureau's Annual Survey of State and Local Government Finances publishes data with a two-year lag. As a result, at the time this book went to press, aggregate state and local government data were not available for 2020. As such, the impact of COVID on state and local governments cannot be seen in the data presented here. However, COVID definitely had a substantial impact on state and local government spending. States incurred significant costs related to unemployment insurance claims, providing COVID testing, providing health-care services, modifying air ventilation systems, creating safe school environments, and so on. Though the federal Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 offset some of these expenses, the extent to which it did so remains to be seen. At the same time, state and local governments experienced precipitous declines in restaurant, hotel occupancy, and sales tax revenues, and smaller decreases in personal and small business income tax revenues. Since state and local governments, unlike the federal government, generally are not allowed to run a deficit, the impact of COVID on increasing outlays and reducing receipts resulted in significant reductions in spending in other areas. Cutbacks in services such as public transportation and higher education were particularly severe.

The Health-Care Services Industry

In 1965, federal legislation was passed creating Medicare and Medicaid. Since then, spending on health care has risen at a rapid rate. In the 21st century, we have seen a shift in the relative sources of financing the health-care sector. Consider a comparison of the private and public roles in paying for national health expenditures over time, as shown in Table 1-7. From 2000 to 2010 the federal government took a much larger role in funding health-care spending. As shown in Table 1-8, the federal government's share of health spending is now projected to remain flat relatively between 2010 and 2025, after having considerably increased between 2000 and 2010, mostly as a result of the ACA's mandate that individuals purchase private health insurance (some with public subsidies) or face a tax penalty. As of 2019, the tax penalty was repealed but the costs of the ACA remain high. Note that these numbers do not take into account any short-term or long-term changes as a result of COVID.

TABLE 1-7 National Health Expenditures, Private versus Public, 2000, 2010, 2020*, and 2025*

	2000		2010		2020*		2025*	
	$ in Billions	Percent	$ in Billions	Percent	$ in Billions	Percent	$ in Billions	Percent
Private	877	64	1,431	55	2,200	55	2,801	53
Public (Federal, State, and Local)	489	36	1,159	45	1,814	45	2,446	47
Total	1,366	100	2,590	100	4,014	100	5,247	100

*Projected.

Source: Actuals abstracted from "Table 5: National Health Expenditures by Type of Sponsor: Calendar Years 1987 to 2019." Projection abstracted from "Table 16: National Health Expenditures (NHE), Amounts and Average Annual Growth From Previous Years Shown, By Type of Sponsor, Selected Calendar Years 2012-2028." Center for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics. https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/index.html.

TABLE 1-8 National Health Expenditures, Private, Federal, and State and Local, 2000, 2010, 2020*, and 2025

	2000		2010		2020*		2025*	
	$ in Billions	Percent	$ in Billions	Percent	$ in Billions	Percent	$ in Billions	Percent
Private	877	64	1,431	55	2,200	55	2,801	53
Federal	263	19	740	29	1,155	29	1,600	30
State and Local	226	17	419	16	659	16	846	16
Total	1,366	100	2,590	100	4,014	100	5,247	100

*Projected.

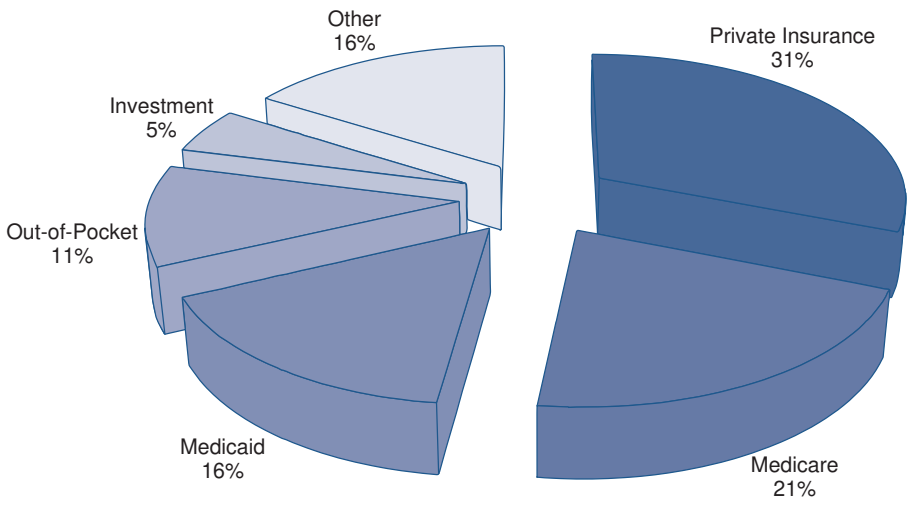
Source: Actuals abstracted from "Table 5: National Health Expenditures by Type of Sponsor: Calendar Years 1987 to 2019." Projection abstracted from "Table 16: National Health Expenditures (NHE), Amounts and Average Annual Growth From Previous Years Shown, By Type of Sponsor, Selected Calendar Years 2012-2028." Center for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics. https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/index.html.

State and local government funding of health care over the period from 2010 through the projection for 2025 grew substantially in absolute terms but only a minor amount as a percentage of national health expenditures, as demonstrated in Table 1-8.

Although COVID clearly stressed the health-care system, with hospitals treating hundreds of thousands, if not millions of COVID patients, and at times running out of critical care beds, with hundreds of millions of doses of vaccine purchased and administered, and other costs incurred, overall health-care spending did not necessarily rise as a result of COVID. Much routine health-care spending was deferred during the pandemic. In fact, health-care "spending for the first ten months of 2020 was 2.3 percent lower than in the first ten months of 2019."[6]

One can get a better sense of the sources of health-care financing from Figure 1-7. Medicare is a federal program; Medicaid and other public programs are paid for by federal, state,

FIGURE 1-7 The Nation's Health Dollar: Where It Came From, Calendar Year 2019



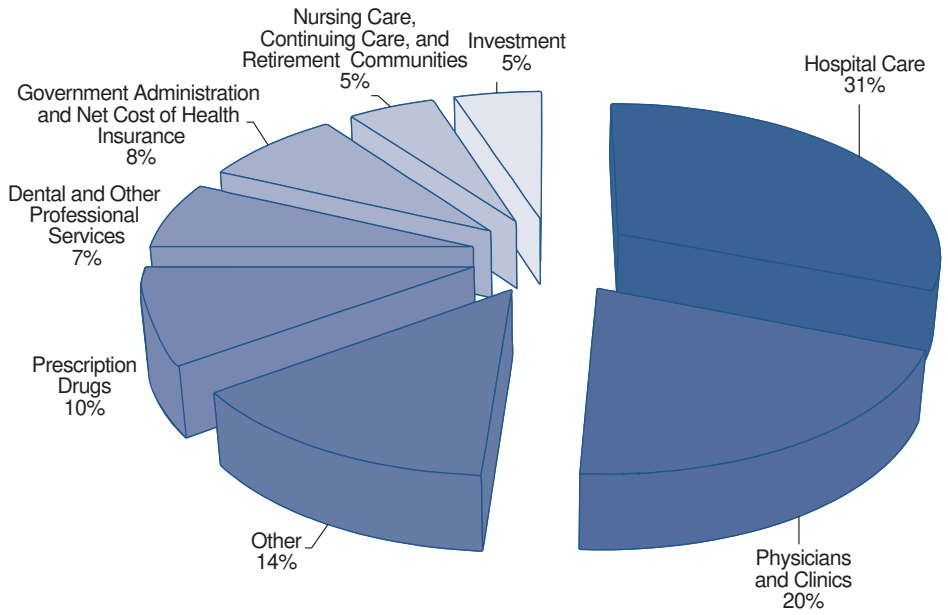
Source: "The Nation's Health Dollar ($3.8 Trillion), Calendar Year 2019: Where It Came From," Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group. https://www.cms.gov/files/document/nations-health-dollar-where-it-came-where-it-went.pdf

[6] George Miller, Corwin Rhyan, Ani Turner and Katherine Hempstead, "COVID-19 Shocks The US Health Sector: A Review Of Early Economic Impacts," Health Affairs Blog, Health Affairs, December 16, 2020. https://www.healthaffairs.org/do/10.1377/hblog20201214.543463/full/.

and local governments. Medicare and Medicaid make up over one third of the health-care pie. Private health insurance, including managed care programs, is the single largest source of funding. The "Out-of-Pocket" category represents direct payments by individual persons for care. The "Other" category includes payments by those other than patients. For example, it includes health services provided for employees at the employer's site.

What is this money spent on? Figure 1-8 provides a breakdown of the total spending. Hospital care, at 31 percent, is the largest single cost driver. Physician services, nursing home care, and prescription drugs are also large objects of expenditure. Other spending includes dental, vision, research, construction, and other medical and nonmedical costs.

FIGURE 1-8 The Nation's Health Dollar: Where It Went, Calendar Year 2019



Source: "The Nation's Health Dollar ($3.8 Trillion), Calendar Year 2019: Where It Went," Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group. https://www.cms.gov/files/document/nations-health-dollar-where-it-came-where-it-went.pdf

The Not-for-Profit Sector

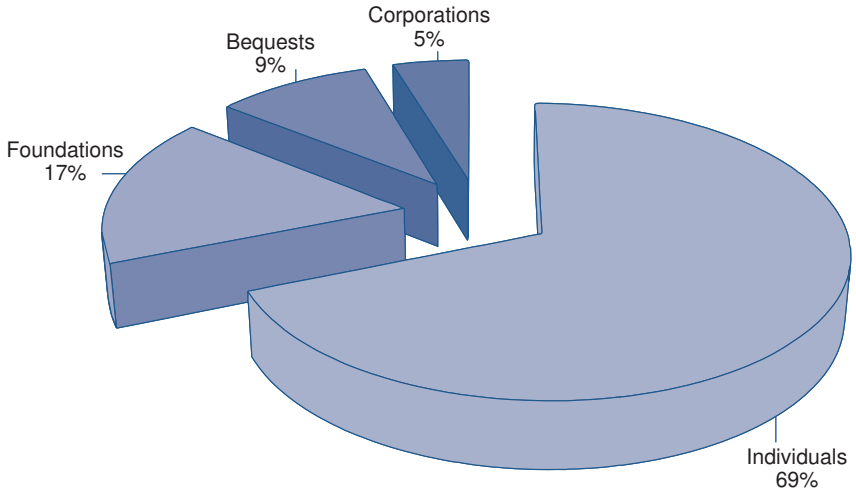
The not-for-profit sector in the United States is extremely large, with over 1.5 million different tax-exempt organizations registered with the US Internal Revenue Service (IRS) as of 2016. The largest single grouping is that of public charities, which number 1.1 million.[7] There is a tremendous range of charitable organizations, including but not limited to those in the arts, culture, and humanities; education; environment; health; human services; international affairs; religion; and foundations.[8]

Although corporations and foundations make substantial contributions to the not-for-profit sector, the largest share of contributions, 69 percent, comes from individuals (see Figure 1-9). There was over $450 billion in charitable giving in 2019.[9] Most American households make

[7] NCCS Project Team, *The Nonprofit Sector in Brief 2019*.
[8] A good source for additional descriptions of and information about various types of not-for-profit organizations is the Urban Institute's National Center for Charitable Statistics at http://nccs.urban.org.
[9] *Giving USA 2021: Highlights: An Overview of Giving in 2020*, researched and written by the Lilly Family School of Philanthropy at Indiana University–Purdue University Indianapolis. Published by the Giving USA Foundation.

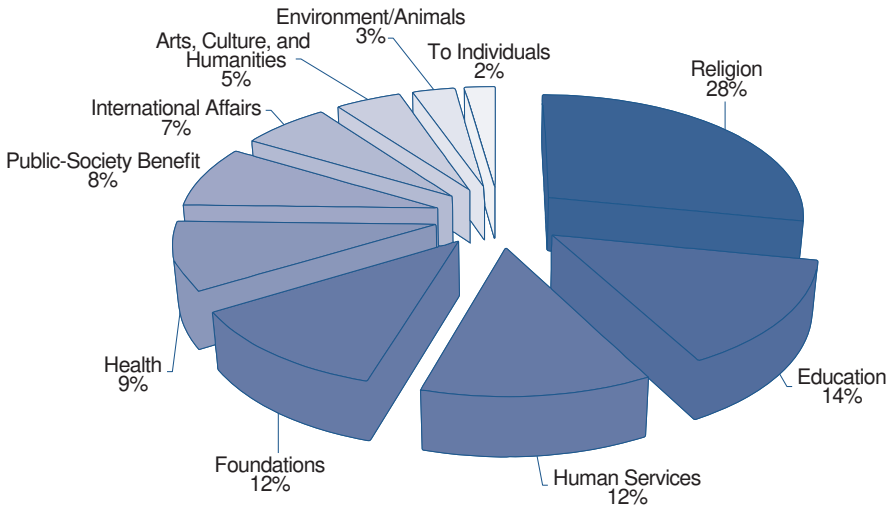
contributions, and in 2016 the average American household gave $2,240 to charity.[10] Contributions are spread across a wide variety of organizations, as seen in Figure 1-10. The greatest share of dollars contributed, 28 percent, went to religious organizations. Education, with 14 percent of the contributions, was a distant second. The not-for-profit sector is not totally, or even mostly, reliant on contributions, however.

FIGURE 1-9 Contributions: $450 Billion by Source of Contribution, 2019



Source: *Giving USA 2020: Highlights: An Overview of Giving in 2019*, researched and written by the Lilly Family School of Philanthropy at Indiana University–Purdue University Indianapolis. Published by the Giving USA Foundation.

FIGURE 1-10 Contributions: $450 Billion by Type of Recipient Organization, 2019



Source: *Giving USA 2020: Highlights: An Overview of Giving in 2019*, researched and written by the Lilly Family School of Philanthropy at Indiana University–Purdue University Indianapolis. Published by the Giving USA Foundation.

[10] *Giving USA 2021: Highlights.*

In 2013 fees for services and goods from private sources accounted for 47.5 percent of public charities' revenues, while fees for services and goods from government sources accounted for 24.5 percent.[11] Not-for-profit organizations, even when they are charities, increasingly rely on earned revenues from clients and sponsors. Clients may be patrons of the gym at the local YMCA, shoppers in a thrift shop, or students at a public university. Sponsors include governmental entities that support service provision to individuals who cannot otherwise afford goods or services. Such clients may be, for example, low-income families who rely on food banks for nourishment. The sponsors' support may come in the form of contracts, or donations and grants.

How do not-for-profit organizations obtain donations and grants? Fundraising has become an important part of the job of managers of not-for-profit organizations. There are two major types of fundraising: contributions or donations, and contracts or grants. The funds that not-for-profit organizations receive from these sources are either with or without donor restrictions. The organization may use funds without donor restrictions for any valid organizational purpose. If the funds have donor restrictions, however, the organization must comply with specific limitations on how the funds may be used.

For example, when Joan Kroc died she left $1.5 billion of the McDonald's restaurant fortune to the Salvation Army. However, the charity had to contemplate whether to accept the gift, because the donation was restricted. If accepted, half of the money had to be used to build 25 to 30 community centers and the other half placed in a permanent endowment, with the income from the endowment used to pay for the costs to operate the centers. Based on the Salvation Army's past experience, it was likely that the endowment income would be enough to pay only approximately half the total operating cost of the centers. By accepting the gift with its restrictions, the Salvation Army essentially committed itself to raising an additional $70 million a year from other sources, after the construction of the centers has been completed.[12] Sometimes gifts create burdens for charities.

Fundraising has become a sophisticated area of management, and many not-for-profit organizations employ full-time staffs that specialize in fundraising, often called development. A brief introduction to fundraising is provided in Appendix 1-A.

The International NGO Sector

The World Bank defined nongovernmental organizations (NGOs) as "private organizations that pursue activities to relieve suffering, promote the interests of the poor, protect the environment, provide basic social services, or undertake community development" (World Bank Operational Directive 14.70). NGOs are similar to the not-for-profit organizations described in the previous section. They are primarily mission-focused rather than profit-focused. Essentially, any not-for-profit organization that is independent from the government can be considered an NGO.

We can think of NGOs as falling into three main categories: community-based, national, and international. Community-based organizations (CBOs) are membership groups that

[11] Brice S. McKeever, *The Nonprofit Sector in Brief 2015* (Washington, DC: The Urban Institute, Center on Nonprofits and Philanthropy, 2015). https://www.urban.org/sites/default/files/publication/72536/2000497-The-Nonprofit-Sector-in-Brief-2015-Public-Charities-Giving-and-Volunteering.pdf.

[12] Stephanie Strom, "Salvation Army Receives $1.5 Billion From Estate Built on McDonald's Franchises," *New York Times*, January 21, 2004, http://www.nytimes.com/2004/01/21/national/21GIFT.html.

advance the interests of the members. They may be anything from farmers or trade associations to clubs or even lending organizations. National NGOs are larger organizations, more likely to have full-time staff that operate solely within a country. International NGOs have a presence in more than one country.

The NGO sector grew at a rapid rate in the last quarter of the 20th century. Each year the revenues and spending of NGOs amount to billions of dollars. A good source for additional information about the international NGO sector is the *Yearbook of International Organizations,* published annually.[13] It provides profiles of over 73,000 intergovernmental and international NGOs.

WHY DISCUSS PUBLIC, HEALTH CARE, AND NOT-FOR-PROFIT IN ONE BOOK?

The reader might wonder why public or government, health care, and not-for-profit financial management are all discussed in one text. One argument for this grouping is that these organizations, for the most part, are exempt from taxes.[14] Although that is something that many of these organizations have in common, it is not the primary issue. The common thread that binds these organizations is their raison d'être, their reason for existence. All these organizations are in the public service. As such, their major focus is to provide benefits to the community.

The underlying public service motivation creates a large number of special circumstances in the area of financial management. Since not-for-profit organizations do not have owners watching to make sure their profits are maximized, there must be other mechanisms put in place to ensure that managers achieve their organization's goals.

Measurement of profit does not adequately provide the bottom line for public service organizations. Since they operate with a goal of providing a public benefit, there must be ways to ensure that the level of public service achieved is measured and reported. Tools must be provided that allow managers to work toward achieving the specific goals of their organizations. This book will help explain those tools and mechanisms, with a special focus on three vital areas: public, health, and not-for-profit.

WHY SHOULD PUBLIC SERVICE ORGANIZATIONS WORRY ABOUT FINANCIAL MANAGEMENT?

If making a profit is not the primary mission of public service organizations, should they even be concerned with issues of financial management? Should organizations such as governments, hospitals, churches, and museums spend time on financial management? The answer is a strong yes.

---

[13] *Yearbook of International Organizations*, Union of International Associations, Brussels, https://uia.org.

[14] Although it is generally true that the public and not-for-profit sectors are exempt from taxation, this is less true for the health-care services sector. This book will address issues related to both not-for-profit and also for-profit, or proprietary, health-care organizations.

In for-profit organizations, profits are the goal. They represent the end result that the organization is trying to achieve. In public service organizations, financial resources are a means to an end. The profits themselves may not be the ultimate goal. However, without adequate financial resources an organization generally cannot achieve its mission.

For example, suppose that an organization's mission is to provide food to homeless individuals. The goal is to keep people from being hungry. To achieve that goal, the organization needs a physical location. It must pay rent and heat and electric bills. Any needed food that is not donated must be purchased. The organization's managers could spend all their time and efforts planning meals, cooking meals, and getting the meals to the homeless. But if they do that, there is a significant possibility that the organization will run out of money and will have to close its doors.

Achieving the goals of the organization requires financial planning. How much will it cost to provide the meals? How much money can the organization expect to receive? From what sources? Are there adequate resources, or will there be a shortfall?

By focusing on financial issues, managers can determine whether to increase fundraising efforts. They can decide if survival requires cutting back from serving three meals per person per day to just breakfast and dinner, or even just dinner. The desire to accomplish the goal of feeding the hungry can work against accomplishment of that goal. Managers can ignore the organization's finances and keep serving three meals a day—finances be damned. But bankruptcy and closure may be worse than cutting back to two meals a day. An understanding of the current financial status of the organization—how well it is doing financially and what it can or cannot afford to do—is essential for all organizations.

The field of financial management involves attempting to generate useful financial information that is free of value judgments. It is not the role of financial managers to say what the organization should do. Financial management can provide information about how many meals a day the organization can afford to provide to how many people, given expected financial circumstances. General managers often must use the information to make decisions. Suppose that the only choices available that will allow the organization to continue to provide meals for the hungry are to limit the number of people served or to change the menu to one with less-nutritious food. Should the organization turn some people away, or should it reduce the quality of the food served? Such value judgments are outside the domain of financial management.

Financial management focuses not only on questions of survival, but also on issues of **effectiveness** and **efficiency**. Effectiveness relates to whether an organization is accomplishing its mission. If there is a goal to feed 1,000 people per month, financial management can assess how effective the organization is in achieving that goal. How many people are in fact being fed? Efficiency relates to whether the organization uses the minimum needed resources to produce its outcomes or outputs. To avoid wasting resources, organizations need to understand their productivity. How much did it cost per person fed? Is the organization maximizing the use of resources by finding the lowest-cost approach for achieving each of its results?

SHOULD PUBLIC SERVICE ORGANIZATIONS EARN A PROFIT?

Okay, so not-for-profit organizations need to be aware of their finances. But should they earn a profit? Again, the answer is yes. The term **not-for-profit (NFP)** is meant to convey the fact that earning a profit is not the mission of the organization. However, organizations clearly

would not want to lose money, because then they might be forced to cease operation. Even further, not-for-profit organizations should not be content to just break even. Earning a profit is essential to almost all organizations.

Although earning profits is not why public service organizations exist, profits enhance that existence. Earning profits allows organizations to better accomplish their goals. This is true for several reasons. First, profits provide an organization with a safety margin. Things do not always go according to plan. If for some reason financial results are poorer than expected, a profit earned in a prior period can make up the shortfall.

Second, organizations must be able to replace their equipment and facilities over time as they wear out. If there is inflation, it will cost more to replace these items than they originally cost. For example, if inflation is 3 percent per year, a piece of equipment that lasts 5 years will cost 15 percent more to replace than it originally cost.[15] So a profit will be needed to allow for replacement of facilities.

Third, organizations often want to be able to expand their services over time. This may be to reach out to more potential clients. Similarly, organizations want to be able to improve their services over time, perhaps taking advantage of new technologies. Some reasonable level of profits is necessary to allow for such expansions and adoptions of technologies.

What about governments? Should they earn a profit as well? Governments' profits are more commonly called surpluses. And one can make a good argument that governments also should attempt to earn at least limited surpluses. Cycles in the general economy tend to cause tax receipts to vary upward and downward from year to year. Often, in the years when tax receipts are low because of a recession, the demand on the government to provide public services, such as unemployment insurance payments and welfare payments, rises. Because the demands of government may be higher at times when tax revenues are lower, many governments plan to have a surplus in good years. This provides available resources to cover needs in bad years. It can also protect the government from unexpected events, such as unusually severe winters requiring extra snow removal or overtime related to cleanup after a rare flood. Governments may have laws governing whether they may incur a surplus or deficit.

Corporate Income Taxes

If a not-for-profit organization earns a profit (surplus), will it be subject to corporate income taxes? No. Organizations that are exempt from federal income taxes, referred to as **tax-exempt** organizations, will not be subject to income tax simply because they earn profits. However, the profits earned must be used for the benefit of the organization and its clients, rather than being used to benefit any select group that might be perceived as receiving the benefits of ownership.

For example, if a hospital gives free office space to physicians for their private practices, the IRS would likely consider that free space to be a distribution of profits to a group of physicians, placing the organization's tax-exempt status at risk.

In some cases, tax-exempt organizations are subject to income tax on profits they earn that come from sources not related to their primary tax-exempt mission. For example, if a

[15] Actually, the cost will increase by more than 15 percent, since the impact of inflation compounds over time. Issues related to compounding are discussed in Chapter 5.

museum operates a restaurant that is open to the general public (beyond just those people visiting the museum), the profits from that restaurant might be subject to income tax (see Appendix 11-A).

Even organizations that are fully tax-exempt are required to file an annual income tax return with the IRS, called Form 990. This document is available to the public either over the internet or directly from the organization. Tax returns of for-profit corporations are private.

Issues related to income taxes can be extremely complex. Although many public service organizations are tax-exempt, all organizations should seek out the advice of competent tax experts to ensure that they are in compliance with the various tax laws.

ONGOING CASE STUDY

This book uses a fictional example to help the reader learn about financial management in not-for-profit, government, and health-care organizations. This case study introduces a wide range of financial management material in a realistic yet simplified setting. The case study will run throughout the entire book, with many chapters adding information to it.

The Setting

The Robert F. Wagner Graduate School of Public Service at New York University was having an alumni reunion. The reunion culminated with a formal dinner in the luxurious Bobst Penthouse faculty dining facility. Sitting next to each other at one particular table on this evening were three persons. Each had known the other two nearly a decade earlier when they had been working on their master's of public administration degrees at the Wagner School. They had gone their separate ways, but on this evening they found themselves in similar positions.

Leanna Schwartz had left the Wagner School and worked in a variety of positions in the not-for-profit field. Having performed in an excellent manner in each position, she had received a series of increasingly important positions. The culmination was that she had just been appointed the executive director of Meals for the Homeless (Meals).

Sitting a few seats from Schwartz was Steve Netzer. He had worked in just one organization since leaving Wagner, the Hospital for Ordinary Surgery (HOS). Working his way up through the ranks, from night administrator to assistant admitting department head to director of medical records, he had recently been promoted to the position of chief operating officer (COO) of the hospital.

In between Netzer and Schwartz was Dwight Ives. He had gone directly into government management upon leaving the Wagner School. After a stint in Washington as a White House fellow, he worked for a number of years in various roles in management in New York City. In a bit of a dramatic change, he had recently taken on the job of town manager for the suburban town of Millbridge.

As the three alumni chatted, they realized that not only had they taken on the most challenging position of their careers to date, but also they now had substantially more financial responsibility than ever before. None of them was a financial manager per se. In fact, none of them had even specialized in financial management while at the Wagner School. However,

each of them would now have financial managers working for them, and each of them would need to have a good working understanding of many basic aspects of financial management to be successful in their positions.

What financial skills will each of these managers need? How will those skills help them oversee their organizations? These are some of the questions that will be addressed throughout this book. Often students in not-for-profit, government, and health-care management and policy programs have difficulty understanding exactly what value financial management has to them. It is hoped that this continuing case study will help the reader understand more easily why financial information is important. That in turn should make it substantially easier to try to absorb the general aspects, and even some of the more technical aspects, of financial management.

SUMMARY

The primary focus of the book is on providing current and future managers with an understanding of financial information. The goal of the book is not to provide a highly technical grounding in accounting and finance. Rather, by the end of this book the reader should be comfortable with the basics of financial management.

Financial management is the subset of management that focuses on generating financial information that can be used to improve decision making. It includes both accounting and finance. Accounting is a system for keeping track of the financial status of an organization and the financial results of its activities. It is subdivided into two major areas. Managerial accounting relates to generating any financial information that managers can use to improve the future results of the organization, and financial accounting provides retrospective information about the results of operations and the financial position of the organization. Finance focuses on the alternative sources and uses of the organization's financial resources.

Public sector organizations obtain their financing from a variety of sources and use them for a wide variety of purposes. Federal government outlays exceeded $6.5 trillion in 2020, and even in pre-COVID 2019 were nearly $4.5 trillion annually. State and local government spending exceeds $3.2 trillion. Spending on health care also exceeds $3.8 trillion each year. Spending by not-for-profit organizations is approximately $2.5 trillion annually. There were $450 billion in charitable contributions in 2019.

In public service organizations, financial resources are a means to an end. The profits themselves may not be the ultimate goal. However, without adequate financial resources one generally cannot achieve the organization's mission. So it is essential for public service organizations to be concerned with financial management. The field of financial management attempts to generate useful financial information that is free of value judgments. It is not the role of financial managers to say what the organization should do. Financial management provides financial information that can help managers make decisions.

Public service organizations should not be content to just break even. Earning a profit is essential to almost all organizations. First, profits provide an organization with a safety margin. Second, organizations must be able to replace their equipment and facilities over time as they wear out. Third, organizations often want to be able to expand their services over time and adopt new technologies. Some reasonable level of profits is necessary to allow for safety, replacement, and expansion. Because the demands of government may be higher at times when tax revenues are lower, many governments will plan to have a surplus in good years. This provides available resources to cover needs in bad years or for unexpected costs.

KEY TERMS FROM THIS CHAPTER

accounting, 2
creditors, 2
debt, 2
deficit, 6
depreciation, 2
effectiveness, 17
efficiency, 17
federal funds rate, 8
finance, 2
financial accounting, 2
financial management, 2
fiscal, 3
gross federal debt, 7
inventory, 2
managerial accounting, 2
national debt, 7
net assets, 2
not-for-profit (NFP), 17
off-budget, 6
on-budget, 6
payables, 2
proprietary, 2
receivables, 2
surplus, 6
tax-exempt, 18
vendor, 2

QUESTIONS FOR DISCUSSION

1-1. What is financial management?

1-2. What is the goal of proprietary, for-profit organizations?

1-3. What is the focus of decisions in public service organizations?

1-4. What is accounting?

1-5. What are the two major subdivisions of accounting? Explain.

1-6. What is finance?

1-7. Is financial management important for public service organizations? If so, why?

1-8. Is it appropriate for public service organizations to earn profits?

1-9. What are the major sources of financing for the federal government, state and local governments, the health sector, and the not-for-profit sector?

1-10. How large is total federal and state and local government spending compared to the US GDP?

1-11. How is it possible for the federal debt to increase in a year when the federal government has a surplus?

1-12. Is there any reason that a not-for-profit organization might decide to decline a gift?

1-13. What is an NGO?

Appendix 1-A

FUNDRAISING

Not-for-profit organizations have three primary sources of funds. One source is simply borrowing money. Often banks and other lenders will provide loans to not-for-profit organizations. A second source is from the sale of goods or services. This is the primary source of funds for many not-for-profit organizations (e.g., hospitals). The third source is from fundraising. This appendix provides a brief introduction to fundraising.

Fundraising is critical to the financial survival of many not-for-profit organizations. It is a broad field with many dichotomies. Funds are raised from either private or public sources. They come from donations or from grants or contracts. Donations may be made with or without restrictions. Fundraising may focus on either operating or capital needs. Donations may come while donors are alive or after they have died. This appendix explains some of the dichotomies and discusses some essential issues of fundraising. However, the chapter is just a brief introduction to this topic.

We often think of fundraising as the process of getting individuals to donate money to a not-for-profit organization. And that is clearly a key element of fundraising. However, it is significantly more complicated than that. Fundraising refers not only to raising money from private sources by generating donations, but also to receiving funds from grants and contracts. Many not-for-profits raise their money from public rather than from private sources. For example, many private not-for-profit universities receive a substantial amount of money from governments.

CONTRIBUTIONS

Contributions are the most basic form of support for not-for-profit organizations. Contributions may be received from individuals, but are often also received from foundations, corporations, or the government. Contributions may be without donor restrictions. In that case, the not-for-profit organization can use them for any reasonable purpose related to the mission of the organization. Alternatively, donors may place restrictions on the use of the contribution. The restriction may be related to time or purpose. A time restriction would indicate that the donation cannot be used before a certain date or must be used by a specific date. A purpose restriction would limit what the organization does with the donation. For example, it is common to restrict donations to pay for construction of a new building, rather than being used for routine operating activities. Endowment gifts are restricted in a way that prohibits them from ever being spent. Instead, such gifts are invested and the organization can use the income from the endowment in accordance with the instructions of the donor.

Donations come in many forms. Donations in cash or by check are easy for the organization. However, for convenience or for tax advantages many donors give items such as stocks and bonds, real estate, computers, clothing, or services. Organizations receiving various types of donations should become aware of tax rules governing the donations.

OPERATING VERSUS CAPITAL

Capital contributions are used to acquire resources that will last for more than 1 year. Operating contributions are used for the routine day-to-day costs of running the organization throughout the year. Frequently, a not-for-profit organization will hold a **capital campaign**, a fundraising drive to raise money to acquire long-term resources. Typically, such a campaign is used to build and equip a new building or to renovate an existing building. Money raised through a capital campaign is usually restricted for use for capital (long-term) acquisitions and may not be diverted to pay for the routine current operating expenses of the organization. Many charities also hold operating-fund drives to generate donations that can be used to pay for current operating costs.

PLANNED GIVING

Often not-for-profit organizations benefit from being creative in their fundraising efforts. Two of the most obvious ways to donate are to just give a gift currently or for a person to leave money to the organization in their will. However, a number of planned giving approaches that are more complicated but have certain advantages have been developed. These approaches often allow donors to get the psychic benefit of donating money while they are alive, while still being able to enjoy the earnings on the money donated during their lifetime. Generally, these arrangements require the establishment of some form of charitable trust.

Once money is placed in an irrevocable charitable trust, donors cannot change their mind and get the money back. Nevertheless, such planned giving has advantages. A **charitable remainder trust** is one in which the donor gets income that is earned on the resources in the trust. When the donor dies, the charity gets the money remaining in the trust, hence its name. One type of remainder trust pays the donor a fixed payment each year. If the income on the trust is not enough to make the payment, some of the principal will be distributed to the donor. The charity may therefore wind up receiving less than the amount originally placed in the trust. Another form distributes a percentage of the trust's assets to the donor each year. If the trust goes up in value due to successful investments, the donor will receive increased annual payments. Alternatively, sometimes trusts are set up where the charity gets annual income from the trusts, but the principal amount passes to the donor's heirs upon the donor's death. Other arrangements are possible as well.

An individual's specific circumstances dictate which approach may be preferable. Most of the approaches have tax implications. Fundraisers should acquaint themselves with the tax law in the area of charitable donations so that they can explain to potential donors the advantages of each approach to planned giving.

CONTRACTS AND GRANTS

Contracts generally involve a quid pro quo. Unlike a donation, which is a gift with nothing expected in exchange, contracts usually provide something to each party. For example, if a corporation signs a research contract with a university, the university will receive funding and the corporation will receive the results of the research study. Grants are often similar to contracts. A foundation might award a grant to a researcher at a university to fund that individual's research. However, a grantor does not receive something in return for the grant in the same way that a contractor does.

This is a fine line of distinction. If a city contracts with Meals to provide meals to homeless people in the city, the city pays only if meals are provided. There might be a contractual arrangement requiring a payment of $8 for each dinner meal provided. On the other hand, a foundation might give Meals a grant of $1 million restricted to providing meals to homeless in the city. Given the mission of Meals, which is to provide meals to the homeless in the city, it will be anxious to obtain both contracts and grants like those described. Often grants and contracts may create a more stable source of funding than relying solely on contributions from individuals.

Governments and foundations frequently have programs that provide funds to not-for-profit organizations. Often they will solicit requests for that funding by issuing a request for proposal (RFP). It is helpful for a not-for-profit organization to place itself on the mailing list of potential funders so that it is aware of any relevant RFPs. Although not-for-profit managers are often familiar with local foundations, exploring new potential grant makers may be a worthwhile activity.

Once an award is received as either a grant or a contract, the not-for-profit organization must inquire about its specific rules and policies before spending begins. That way the organization can ensure that it spends money only on allowable items and that it gathers all financial information needed to be in compliance with any reporting requirements related to the grant or contract.

RAISING MONEY

Most not-for-profit organizations find that, although they receive some unsolicited donations, they must ask for contributions or grants to have adequate financial resources to achieve their mission. Fundraising can be very time-consuming, and it is common for not-for-profit organizations to employ a development officer who directs their fundraising efforts.

The role of the development officer is to prioritize, prospect, cultivate, and solicit. First, there is a need to determine the highest priorities for funding. Is the organization most desperate for funds for routine operations, a new building, or a new program? Prospecting refers to researching potential donors to determine what is important to them and what would be the largest gift that they could afford. This includes not only researching individuals, but also finding the best mailing lists to use for direct mail campaigns and other efforts. Cultivating refers to the process of educating the potential donors about the organization, its needs, and the difference it makes. Again, this is a broad topic. It may call for a personal visit by the development officer and the chief executive officer (CEO) of the organization or for direct mail of a carefully designed brochure that educates about the organization, without directly asking for donations. Solicitation is the final step where the donor is actually asked for a gift.

Although the development officer will visit some potential donors, not all donations are solicited in a one-on-one process. There are many approaches to fundraising. Girl Scouts sell cookies. For many years Jerry Lewis held an annual television telethon for the Muscular Dystrophy Association. Public television stations run "begathons," where they offer premiums (tote bags, coffee mugs, etc.) for donations. There are $1,000-a-plate dinners, charity balls, golf tournaments, picnics, car washes, and bake sales. There is direct mail and telephone solicitation. Not-for-profit managers should try to be creative in determining approaches that will be sensible and successful for their organization.

Key Terms from This Appendix

capital campaign, 22
charitable remainder trust, 23

Planning

2

Planning for Success: Budgeting

Organizations are not successful by accident. It takes careful thought and planning to excel. What is the organization trying to achieve? Why does it want to achieve that goal? How does it intend to translate that goal into results? The most successful organizations are the ones that specifically address these questions, rather than simply letting things happen. The budget is the organization's plan.

In the sphere of public service, budgeting is complicated by the fact that not all activities are directly related to maximizing the organization's profit. Although earning a surplus is a healthy financial result, governments, health-care organizations, and not-for-profit organizations often undertake activities that will not earn an immediate financial return. What is the benefit from spending additional resources for teaching math in public schools? In the long run, society is likely to benefit. In the budget for the coming year, however, this will simply be an additional expenditure. Planning is accomplished by establishing the mission for the organization, defining a strategy to accomplish the mission, developing a long-range plan that defines the organization's financial and nonfinancial objectives, and preparing specific, detailed budgets that define the resources needed to accomplish its goals and objectives.

The budget describes where resources will come from and how they will be used. As part of the budgeting process, it is essential to communicate goals to the people who must achieve them, forecast future events, develop alternatives, select from among alternatives, and coordinate activities.

LEARNING OBJECTIVES

The learning objectives of this chapter are to:

- define mission and describe the role of mission for public service organizations;
- define strategic plan and discuss the importance of selecting a strategy and identifying goals for the organization;
- explain the role of the long-range or operating plan in setting the organization's specific objectives to aid in achieving its goals;
- define budget and explain how the budget provides the detailed plan for accomplishing the objectives defined in the long-range plan;
- define and discuss different types of budgets, including special purpose, operating, capital, and cash budgets;
- explain the budgeting process, including budget preparation, review and adoption, implementation, and evaluation of results; and
- acknowledge the political aspects of the budget process.

The budget process includes the preparation of budgets; their review, revision, and ultimate adoption; their implementation; and evaluation of the results after the fact. A primary responsibility of management is to control results. Control represents a process of trying to keep to the plan. This is done by motivating people to achieve the plan, evaluating performance of both organizational units and individual persons, and taking corrective action when things are not going according to plan.

These issues are discussed in this chapter. Chapter 3 picks up where this chapter leaves off, looking at a variety of additional budgeting issues for governmental, health, and not-for-profit organizations. It examines a number of different types of budget presentations and ways to organize budgets, and also discusses a variety of budgeting techniques. That chapter finishes with a discussion of some unique aspects of budgeting for governmental organizations.

MISSION

The organization's **mission** represents its raison d'être. Public, health-care, and not-for-profit organizations have missions that relate to providing a public service. Their mission may be to improve society by providing wide access to culture—through museums, opera, ballet, or symphony. Or the mission may relate primarily to healing the ill or feeding and sheltering the poor. For government, the mission may be to provide essential common services such as police, education, sewers, and fire protection.

For public, health, and not-for-profit organizations, then, profitability is a means to an end rather than the end itself. To some extent, the health-care industry is becoming more and more a part of the for-profit sector. Similarly, the for-profit education sector has grown. For such proprietary public service organizations, profits do play an important role in the organization's mission. However, their profit motive must be balanced with the public service elements of their mission.

Chapter 1 introduced Meals for the Homeless (Meals)—a hypothetical organization. One of the first activities for Leanna Schwartz, the new executive director of Meals, would be to examine the **mission statement.** To lead the organization, she must be thoroughly familiar with what the organization hopes to achieve.

A good mission statement answers five questions. The first three define the **domain** of the organization. They are, *"What* does the organization plan to do?," *"Who* will it serve?," and *"Where* will it operate?" The fourth is, *"How* does the organization plan to deliver its services?," and the final question is *"Why* has Meals for the Homeless chosen its specific social purpose?" Here is the mission statement of Meals:

> Meals for the Homeless recognizes the plight of the homeless residents of Middle City, and we hold that society must ensure at least some minimal level of food security for these individuals. It is, therefore, the mission of Meals for the Homeless to provide food to the homeless in Middle City whenever a homeless individual's nutritional needs are not being met by other sources.

Like all good mission statements, the mission of Meals includes both breadth and limitations. A mission should be targeted. If the goal is to do everything for everyone, the mission is unlikely to be achieved and the organization will lack clear direction. If the mission is too narrow, it may not provide the organization with sufficient challenge to sustain itself over time.

In the mission statement for Meals, there is breadth in that the goal of the organization is to meet the nutritional needs of every homeless person who cannot get food from other

sources. The limitations are that the organization is geographically limiting its efforts to Middle City and to supplying food. It is not providing jobs, shelter, medical care, or other services.

STRATEGIC PLAN

Once the organization has a clearly defined mission, it can develop its **strategy** for accomplishing that mission. The **strategic plan** defines the primary approaches that the organization will take to achieve its mission. Generally, strategic plans do not have specific financial targets. However, they set the stage for specific, detailed budgets.

The mission of Meals is to ensure an adequate supply of nutritious food for the homeless. It could attempt to achieve that mission by a large number of approaches. Meals could be a lobbying organization, raising money and using it to lobby for legislation requiring the government to provide nutritious food to the homeless. Another strategy would be to start a "take a homeless person to dinner" campaign. This approach would consist primarily of advertising, with a goal of encouraging the general public to buy meals and give them directly to homeless people. The general strategy that Meals has taken is to solicit donations of food and money, and to use those resources to prepare and serve meals directly to the homeless. Meals uses two delivery trucks and one soup kitchen to carry out this strategy. This was pretty much the way things had been for the past 10 years, despite a growing number of homeless in Middle City.

When Leanna Schwartz became executive director of Meals she decided that it had a clear mission. It also had an overall strategy or approach for accomplishing that mission. However, it had no broad goals. As a result, as the needs of the homeless grew, Meals had not responded. Therefore, as one of her first priorities, Schwartz decided to form a subcommittee from her board of directors to establish a more formal strategic plan, including a set of goals for the organization. The strategic plan would serve as a link between the mission and activities that the organization would undertake to achieve that mission.

As part of the new strategic plan, Meals developed the following goals:

- Directly provide nutritious meals to the homeless of Middle City.
- Directly provide nutritious meals to the indigent in Middle City's public housing.
- Increase the fraction of the target population served from 20 percent to 60 percent within 5 years.
- Expand funding sources to cover the increase in services, including corporate sponsorships and direct fundraising.

Schwartz was pleased with this set of goals. She believed that it pointed the organization in the direction its mission dictated. She also believed that it gave her some tangible targets to work toward. The next step would be to translate the goals of the strategic plan into attainable objectives.

LONG-RANGE PLAN

While the strategic plan establishes goals and broad strategies, the **long-range plan** (sometimes referred to as the operating plan) considers how to achieve those goals. Long-range plans establish the major activities that will have to be carried out in the coming 3 to 5 years.

This process provides a link between the strategic plan and the day-to-day activities of the organization. Organizations that do not prepare a long-range plan are often condemned to just sustain current activities, at best. Many managers simply try to replicate the current year's results when they plan for the coming year. They take whatever has happened, add a few percentage points for inflation, and assume that they have an adequate plan for the future.

The problem with that approach is that after 5 years the organization will likely be exactly where it is today. It will be providing the same quantity and quality of services. It will not be able to look back at where it was 5 years ago, compare that to where it is today, and find that a satisfying amount of progress has been made. Most public service managers believe that they are trying to achieve something. They do not work in the field just to collect a paycheck, but rather to provide some service to society. Given that, it does not make sense to try to sustain operations without any significant gains over time.

Management needs vision. Great managers are those individuals under whose stewardship organizations make great strides forward. In some cases, vision may come from inspiration that only a few people ever have. In many cases, however, vision is a result of hard work and careful planning. It is the result of taking the time to think about the organization's mission, form a strategic plan with goals, and then establish the tactics to carry out that plan and achieve the goals.

For example, one element of the strategic plan for Meals is expansion of meals provided from 20 percent to 60 percent of the target population. This cannot be achieved by simply carrying out the existing daily routine, day after day, year after year. Nor can it happen overnight. A long-range plan must be developed that will specify how the organization expects to achieve that goal.

The managers of Meals will have to determine what must happen to attain its goals. Schwartz would likely start by having conversations with many interested parties about how best to get meals to the poor of the city. Then, a variety of approaches or tactics might be considered. Finally, a long-range plan will be formulated.

The long-range plan should focus on both financial and nonfinancial issues. For example, there are many dimensions to quality in providing a service. How long do the homeless have to wait in line for the meal? Do the homeless like the way the food tastes? What is the relationship between each soup kitchen and its community? Organizations, especially public service organizations, need to be concerned with more than just the number of units of service provided **(output).** The number of meals served is important. But Meals' long-range plan should more broadly help it to achieve its desired **outcomes.** Outcomes are the results that the organization is trying to achieve. These objectives are not all easily quantified in financial terms.

For example, Meals' mission calls for providing the homeless with an adequate amount of nutritious food. Therefore, a desired outcome is providing the homeless with nutritious meals. To achieve its mission, Meals might adopt a strategy of ensuring its meals meet all federal government daily recommended levels for a balanced diet. The long-range plan needs to include specific tactics for that strategy. Meals' long-range plan may indicate that every meal must contain some protein, fat, carbohydrates, vegetables, and fruit. The organization will only deem itself to be effective if it not only provides meals to enough homeless, but also provides meals that meet its nutritional targets.

Some objectives are more directly tied to financial issues. After gathering input and considering choices, Schwartz might decide that the most efficient way to expand from 20 percent to 60 percent coverage (the goal) would be to add three new locations, strategically located to be readily accessible to the largest number of homeless, and to add four more vehicles to its current fleet of two (specific tactics to achieve the goal). These changes will require specific financial resources.

All these tactics could probably be carried out within 3 months, except that the organization does not have the money for the expansion. Money will be needed to buy equipment and

vehicles, pay rent, buy food, and hire staff. The long-range plan will also have to address how to raise the money and when to spend it (more tactics). A reasonable long-range plan for Meals might include the following objectives:

Year 1: Establish a fundraising campaign and begin fundraising. Raise enough money to open one new site.
Year 2: Add a food distribution/soup kitchen location. Raise additional money to acquire and operate a vehicle and open another location. Solicit more restaurants for leftover food donations.
Year 3: Add another food distribution/soup kitchen location and a new vehicle. Raise additional money to acquire and operate a vehicle and open another location. Solicit more restaurants for leftover food donations.
Year 4: Add another food distribution/soup kitchen location and a new vehicle. Raise additional money to acquire and operate two vehicles. Solicit more restaurants for leftover food donations.
Year 5: Add two new vehicles. Raise additional money to begin replacement of old kitchen equipment and old vehicles. Get enough contributions to at least reach a steady state in which replacements take place as needed.

As can be seen from the preceding objectives, unless planning is done in Year 1 to raise money, the organization will never be able to undertake the acquisition and expansion in Years 2 through 5. The organization cannot be satisfied with raising enough to get through the coming year. For it to thrive, rather than merely survive, it must think ahead. The long-range plan provides the opportunity to think ahead prior to making budgets for the coming year.

The objectives included in the long-range plan can be thought of as quantified targets. These targets can relate to both inputs and outputs. For example, we can think in terms of specific fundraising objectives, specifying the total dollar amount of donations we plan to receive each year over the coming 5 years. We can also think in terms of the specific number of delivery trucks to be purchased. These targets or objectives make it possible to create specific, detailed budgets for the organization in financial terms.

BUDGETS

What is a **budget**? It is simply a plan. The plan indicates management's objectives and shows how it expects to obtain, pay for, and use resources to achieve those objectives. In some cases, the plan may be the result of enacted legislation. The budget indicates the amount of money that an organization expects to earn and receive from all sources for the period it covers, which is usually a year. It also indicates the amount of resources the organization expects to use in its operations, and the amount of money that it will pay for those resources. Thus, it provides managers with a detailed action plan. Based on the information in the budget, managers make decisions that they believe will help them carry out the plan and therefore accomplish the organization's objectives.

Budgets must be developed to plan for the accomplishment of goals and objectives. The process requires that a number of predictions and decisions be made. How many homeless will there be next year? What percentage of the homeless will be children? How many workers should the organization assign to fundraising? How many restaurants should be solicited for food? What vehicles will be purchased, and at what price? How much will kitchen employees be paid per hour and in total for the coming year? How much money will Meals receive in donations each month of the year? All these questions and many more must be answered in the process of developing the budgets for the organization.

Virtually all managers become involved in creating and using budgets. Budgeting is not the sole domain of financial managers. Budgets establish the amount of resources that are available for specific activities. As we learn from economics, resources are not unlimited. They must be used wisely. Organizations attempt to do this by planning the activities they will undertake and how much they will spend on them. However, budgets do not merely limit the resources that can be spent. They help the organization achieve its goals and objectives.

Budgets help the manager understand whether the organization expects that its financial inflows will exceed its outflows and a surplus (profit) will occur, or if outflows will exceed inflows, resulting in a deficit (loss). If the latter is the case, the budget may indicate how the organization plans to cover that deficit without having to cease operations. As discussed in detail below, how those inflows and outflows are measured and timed may make all the difference in assessing an organization's budgetary expectations.

Budgeting for governments as compared with budgeting for other types of public service organizations is significantly different. It is common for decisions by the board of trustees of a not-for-profit organization to require that the budget for the organization not show a deficit. In carrying out the plan, however, many times a not-for-profit organization will actually spend more than the amount in the approved budget, sometimes resulting in a deficit. For governments, however, by law the amount that is actually spent generally cannot exceed the budgeted amount. As a result, governments tend to place more controls on spending, and the options available to government managers are often more limited than those available to managers of other types of organizations. Also, governments overwhelmingly focus their planning on cash inflows and outflows, whereas not-for-profit organizations generally take a more comprehensive approach to budgeting.

Often, balancing the budget results in limiting services provided. This is true for all kinds of public service organizations. It is frustrating to managers to have to limit the amount of services provided to the organization's clients. However, it is worse to run out of money and to have to stop providing any services at all. Failure to plan carefully can result in a level of spending that exceeds an organization's resources and leads to a financial crisis; in some instances, the organization will even be forced to cease operations.

Special Purpose Budget

Although most organizations prepare broad annual budgets that are intended to include all their activities for the year, at times a special opportunity may arise. An organization may wish to consider undertaking an activity, but there is no money set aside for it in the annual budget. This does not necessarily create an insurmountable roadblock. At any time during the year, a **special purpose budget** can be developed for a specific project, program, or activity. The organization can then decide whether it wishes to undertake the activity based on the proposed special purpose budget.

For example, suppose that Steve Netzer, the new chief operating officer (COO) of the Hospital for Ordinary Surgery (HOS), has an idea for a program that could help the public and might generate additional patients for the hospital. He would like to send nurses to local supermarkets to offer free blood pressure screenings. The hospital would pay for the nurses and the supplies. The costs of the nurses and supplies are **expenses.** Expenses are the resources used or consumed in the process of providing goods and services. The hospital expects to earn **revenues** from supermarket customers who become patients as a result of medical problems uncovered by the screening. Revenues are the resources the organization earns in exchange for providing goods or services.

Will the extra revenues from these new patients be enough to cover the expenses of care provided to them as well as the expenses related to the screening? A special budget comparing all the expenses and revenues can provide the information needed to answer this question.

If the revenues exceed the expenses as a result of the program, then a **profit** will be earned. Profit is simply the excess of revenues over expenses and is sometimes referred to as a surplus or as net income. If the expenses exceed the revenues, the excess of expenses over revenues is a loss or deficit. Once the expected profit or loss is known, the organization can decide if it would like to implement the plan. It is not necessary to wait until the next annual budget cycle to consider and implement special budgets.

Depending on the financial magnitude of the special activity, the organization's management may be able to approve the activity, or it may require approval by the board of directors, governors, or trustees. In the case of governmental bodies, the additional activity may constitute a change in the overall budget, and it is essential to ensure that such a change is legal.

CASE STUDY

SPECIAL PURPOSE BUDGET

To develop a more detailed special purpose budget example, assume that Dwight Ives, the town manager of Millbridge, received a call from one of the churches in town. The church had a very rudimentary accounting system, recording cash receipts when received and cash payments when made. As long as the church had money in the bank, its governing body assumed that everything was okay. When it ran out of money, the church made special appeals to its congregants. Over the years, this had created several financial crises, such as the winter when the boiler died and the church had no heat for weeks. In that instance, as now, the parish priest, Father Purtell, had asked his friend the town manager for advice on financial planning.

Father Purtell's current problem involved a proposal by some congregants to send a group of teenagers to the Holy Land for about two weeks during the coming summer. The concept called for the families of the students to pay part of the cost, the students to hold fundraisers, and the church to provide a subsidy. The church elders believed that the church could afford to contribute $5,000 to the program, but that was all. Father Purtell had no idea how to decide how much to charge the families and whether the trip could be arranged within the limits of the subsidy. He did know that a decision must be made soon so that there would be time to enroll teenagers in the program and make all the necessary airline and hotel reservations. He called on Dwight for some advice. What did he think? Could the church run the program? He was worried about the consequences if it turned out that the church had to provide a subsidy above the $5,000.

Dwight's first questions involved whether Father Purtell was comfortable with the basic concept: Was the church in the business of setting up trips to Israel? Did such a trip make sense, given the mission of the church? Father Purtell explained that he strongly believed that the concept of the trip was an appropriate church activity. First, the church was always struggling with developing programs to keep teenagers active with supervised activities during the summer months. Second, the visit to the Holy Land would include stops in Bethlehem and Jerusalem. The potential positive religious experience for young impressionable minds could not be surpassed by any other program he could imagine. Since the program did fit nicely with the overall mission of the church, Dwight indicated that the next step was to develop a plan to determine if the program could work. Only by developing a plan could one have an idea of how much to charge families and whether the program would likely be financially feasible.

Dwight suggested that they start the plan by calculating the profit or loss from the program. "How many participants are you expecting, and what will you charge them?," asked Dwight. "That's the problem," Father Purtell replied. "I want to have enough participants and charge them the right amount so that the program can work. Can't we calculate that? Maybe we should start with the costs and then determine the necessary price."

Dwight explained that he thought the father was starting the process without gathering enough background information. The first element of the plan should be an environmental scan. What other trips to the Holy Land are available? How are they similar and dissimilar from what the church had in mind? What do other organizations charge for the trip? Why might some people prefer what the church was offering? Even if the trip fit with the church mission, was there really a need for the church to get into this new venture? Dwight cautioned that one must look around outside the organization to see what others are or are not doing before developing a reasonable plan for the organization's proposed activity. Father Purtell agreed, and they scheduled a meeting for one week later.

At the next meeting, Dwight Ives and Father Purtell discussed the results of the environmental scan. The priest was grateful for having taken the approach. In his mind, he relayed to Dwight, he had assumed that at least half of the teenagers in his parish would jump at the opportunity to go on the church-sponsored trip. Having talked to travel agents, school authorities, a group of interested parents, and others, he had learned a lot. In fact, there were few if any formalized programs that would compete with the church for a trip to the Holy Land. However, a number of travel agents had attractive family packages, and some families had already purchased airline tickets and made hotel reservations for family trips to the Holy Land. The travel agents also had pointed out that many families make travel plans early, with a variety of destinations, and he should consider that. In fact, based on conversations with parishioners, he found that to be the case. He also found out that many of the teenagers already had plans to return to summer camps they had gone to in the past.

Based on his environmental review, he now believed that he could attract a group of 30 to 50 teenagers if the price was right. Travel agents were charging about $2,500 per person for a similar trip. His trip had the added advantage of church chaperones and the benefit of the youngsters being able to spend a lot of time with other children their age.

Dwight thought that by using this they could start to develop a specific plan. He explained that a budget was needed to decide if the project was feasible. He sat down with the father near his computer and turned on a spreadsheet program, Excel.[1] Dwight suggested that they set up the budget in terms of anticipated receipts and payments related to the program. He typed in headings, resulting in Table 2-1.

"Whoa!" Father Purtell said. "What is that line for **uncollectibles**?" Dwight explained that it was certainly likely that some people would make a deposit but would never fully pay for the trip. It would be very risky to assume that everyone would pay the full amount charged. They then discussed the fact that to estimate the revenues they would need to project both an anticipated number of participants and an estimated price. They would also need to know what types of expenses would be incurred. They gave this some thought, trying to anticipate all the different things on which money would have to be spent. Working together, they generated Table 2-2.

The priest decided that 30 teens would be an easily obtainable goal, and he wanted to start out seeing if the church could afford the program making conservative assumptions. Line 6 in Table 2-2 shows the 30 teens. The value in line 6, column B, was then multiplied

[1] Excel is a registered trademark of Microsoft. There are a number of other spreadsheet programs, such as Apple Numbers, Google Sheets, Gnumeric, and Open Office.org Calc.

TABLE 2-1 Holy Land Trip–Special Purpose Budget

	A	B	C
1	***CHURCH OF MILLBRIDGE***		
2	***Budget***		
3	**Holy Land Trip**		
4			
5	**PROJECTED RECEIPTS**		
6	**Charges**		
7	**Less Uncollectibles**		
8	**Net Charges**		
9	**Fundraising**		
10	**Total Receipts**		
11			

TABLE 2-2 Holy Land Trip—Special Purpose Budget: Draft

	A	B	C	D
1	***CHURCH OF MILLBRIDGE***			
2	***Budget***	***Projected***	***Per***	
3	**Holy Land Trip**	**# of People**	**Person**	**Total**
4				
5	**PROJECTED RECEIPTS**			
6	Charges	30	$2,000	$ 60,000
7	Less Uncollectibles			(1,800)
8	Net Charges			$ 58,200
9	Fundraising	30	250	7,500
10	Total Receipts			$ 65,700
11				
12	**PROJECTED PAYMENTS**			
13	Airfare	32	$1,000	$ 32,000
14	Hotels	30	1,200	36,000
15	Chaperone Salaries	2	3,000	6,000
16	Food	32	600	19,200
17	Admission Fees	32	250	8,000
18	Guide	1	3,000	3,000
19	Local Transport (Bus)		2,500	2,500
20	Entertainment	32	300	9,600
21	Other	32	200	6,400
22	Contingency Fund			2,500
23	Total Payments			$125,200
24				
25	Projected Surplus / (Deficit)			$ (59,500)

by an assumed charge of $2,000 (line 6, column C) to get the total charges of $60,000. After discussion, Dwight and the priest decided to use 3 percent of total charges as an estimate for uncollectibles. Assuming that each student not only paid $2,000, but also raised $250 through fundraising activities (e.g., bake sales, car washes), there would be an additional $7,500 in receipts. Dwight believed this was a bit ambitious, but the father thought it was an attainable goal. He felt that if each teen committed to raising those funds, they would value the trip more and get more out of it. Dwight remained skeptical.

Based on his discussions with travel agents, Father Purtell was sure he could get airfare for $1,000 or less. With a guarantee of 30 or more teens, the price would probably be substantially less. To be conservative, however, they used the $1,000 airfare. The father decided that there would have to be one chaperone for every 15 teens. With 30 teens anticipated, there would be two chaperones, and their airfare was included.

They would need hotels for 15 nights. Hotel expenses were calculated based on what the travel agents said they could get, assuming double occupancy. The hotel expenses were calculated, therefore, at $80 per person per night. For $160 per night per room, they should be able to get something reasonable. The room cost was therefore $1,200 per teen ($160 per room ÷ 2 teens per room × 15 nights). The travel agents assured him that hotels would provide free rooms for the chaperones if he booked rooms for the rest of the group.

The rest of the payment or expense budget was generated based on similar discussions, through line 21. When they got to line 22 Dwight suggested a contingency fund. "What for?," asked Purtell. "What will that money be used for?" Dwight explained that he had absolutely no idea. "That's why it's called a contingency fund. If we could identify something we need to spend money on, we'd list it specifically. This is to protect the church against costs it does not anticipate. Remember, you have no experience running trips of this sort." They finally agreed on a lump sum $2,500 contingency fund.

When the projected deficit was calculated, Father Purtell was devastated. "We only set aside $5,000 for a subsidy, not $60,000!"

Dwight was less dejected. "A budget is a plan," he pointed out, "but we can work some more on the plan. Things don't always work out the way you first plan them. That's why we go through the planning process rather than just going full steam ahead." He suggested that the father spend a week working on each revenue and expense category, getting more information, and making some choices about the existing plan.

The next week they met again. "I've made some decisions," the father explained. "Let's put them in the computer and see what happens." He then relayed the following details to Dwight.

1. Raise the price to $2,500.
2. Raise the number of teens to 50.
3. Lower the airfare to $600.
4. Lower the hotel cost to $40 per person per night.
5. Change the chaperone salaries to zero.
6. Cut the admission fees per person in half.

Dwight started to protest about several of the changes, but he changed the numbers in the spreadsheet, which automatically recomputed all the math, resulting in Table 2-3. The priest was elated when he saw the result.

"But how do you justify all of these changes?" Dwight gasped.

"Aha!" responded Father Purtell. "As you said, I just had to examine the plan and see what could be done about it."

"But you can't expect to raise the price and raise the number of participants," Dwight argued. "That flies in the face of the laws of supply and demand."