Introduction: Setting the Stage

1 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

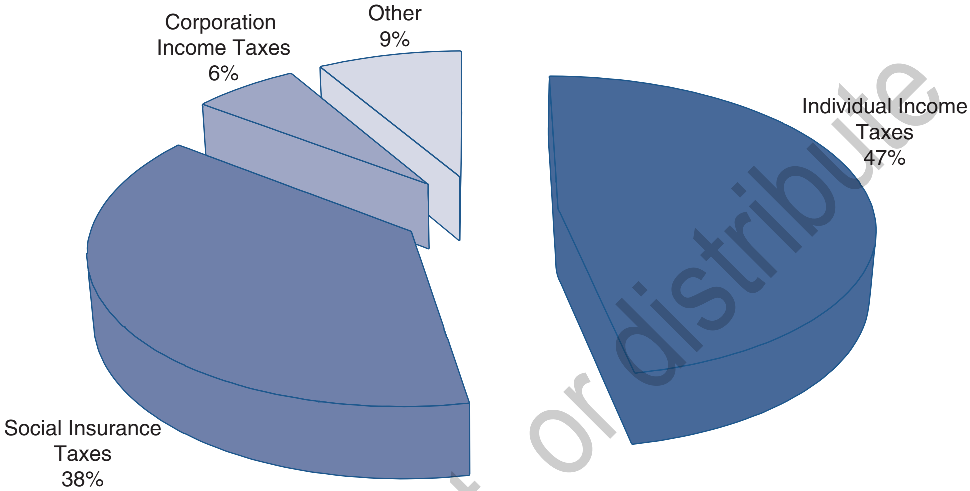
* 2020 values are estimates.
Source: Abstracted from "Table B–47, Federal receipts and outlays, by major category, and surplus or deficit, fiscal years 1955–2020," *The Economic Report of the President, 2021* (Washington, D.C.: United States Government Printing Office, 2021), 512.

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)

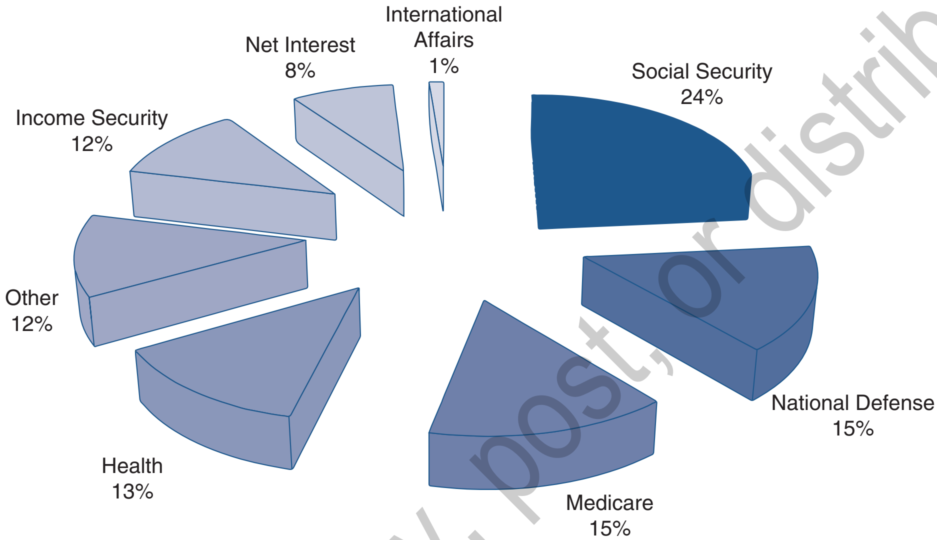
Outlays	2019	2020
Income Security	$ 515	$1,263
Social Security	1,044	1,096
Medicare	651	776
Health	585	748
National Defense	686	726
Net Interest	375	345
International Affairs	53	68
Other	539	1,531
Total	$4,448	$6,553

* 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



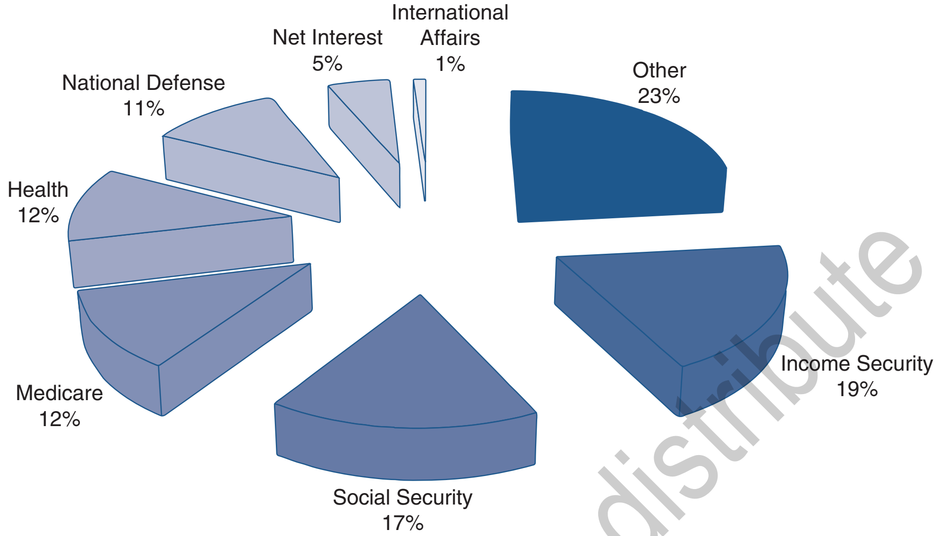
Source: Derived from "Table B-47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1955–2020," *The Economic Report of the President, 2021* (Washington, DC: United States Government Publishing Office, 2021), 515.

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.

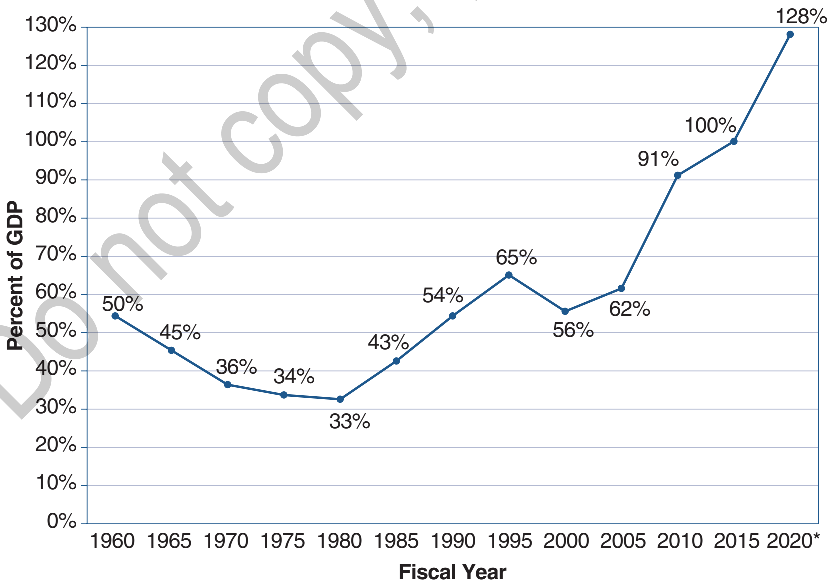
receipts and disbursements, one could argue that the total receipts and total outlays reported in Table 1-3 are reasonable. Others would argue that Social Security collections in excess of Social Security payments should not be used to offset general government spending. Those monies are collected with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

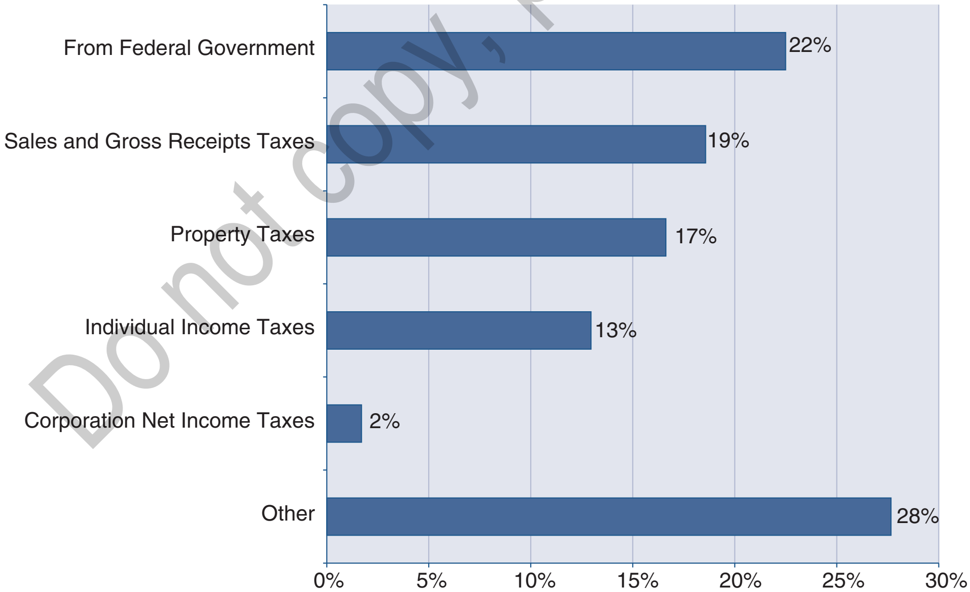
State and local governments rely on each of these sources to varying degrees, and not all state and local governments have the same mix. For example, local governments tend to rely heavily on property taxes, whereas state governments do not. Also, not all states have income taxes on individuals or on 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.

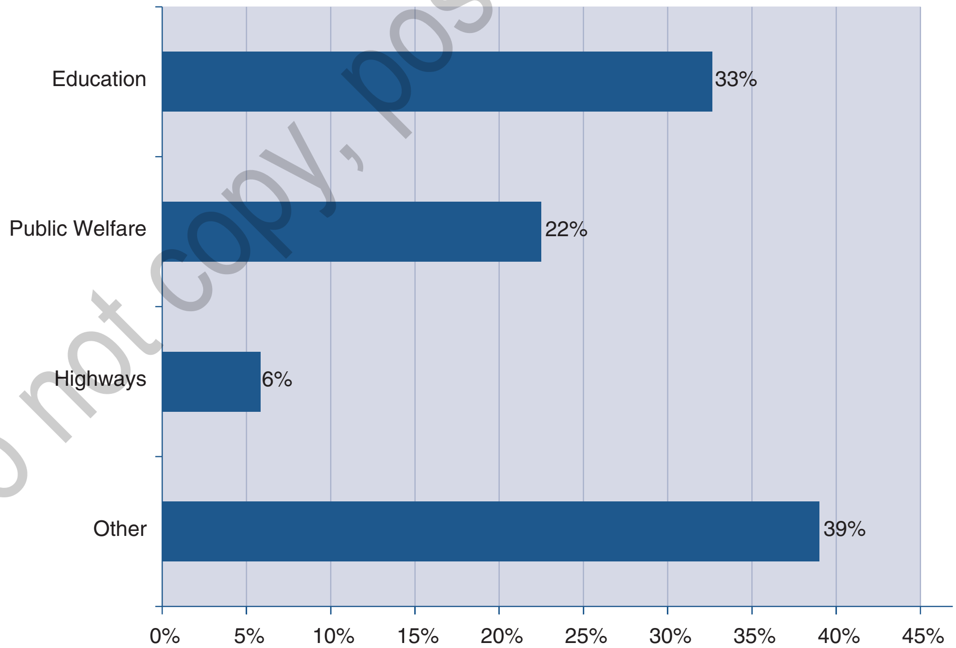
Table 1-6 and Figure 1-6 show how state and local governments use their resources. The single largest object of expenditure is education, representing 33 percent of state and local outlays. Public welfare and highways are other significant items for state and local governments. Note that 39 percent of 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.

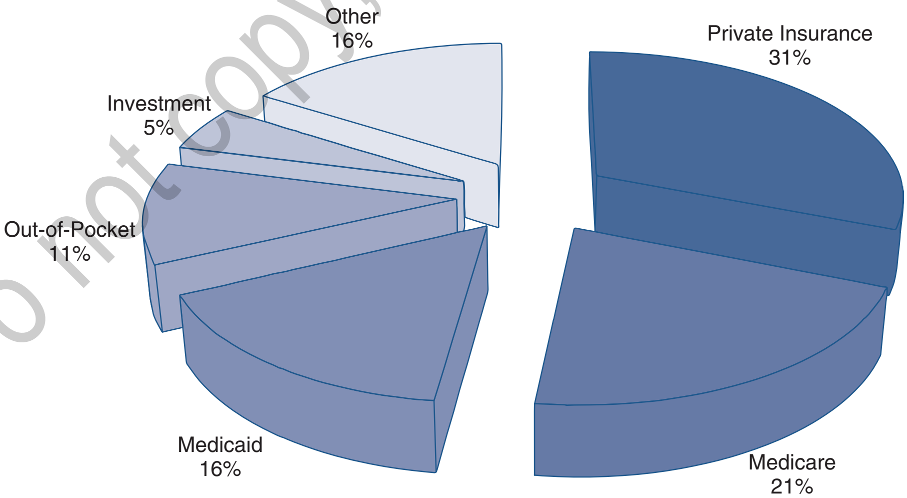
Source: Actuals abstracted from "Table 5: National Health Expenditures by Type of Sponsor: Calendar Years 1987 to 2019." Projection abstracted from "Table 16: National Health Expenditures (NHE), Amounts and Average Annual Growth From Previous Years Shown, By Type of Sponsor, Selected Calendar Years 2012-2028." 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



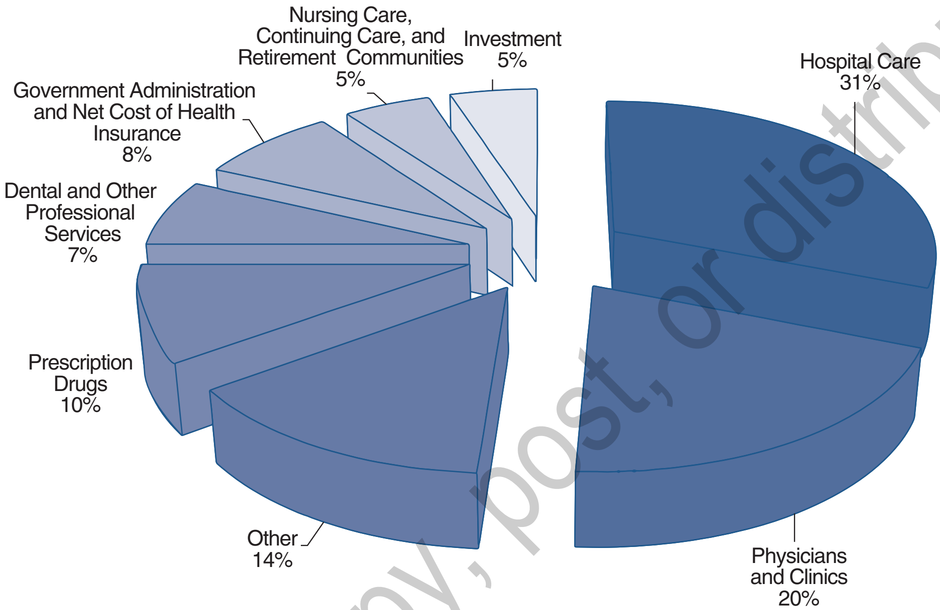
Source: "The Nation's Health Dollar ($3.8 Trillion), Calendar Year 2019: Where It Came From," Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group. https://www.cms.gov/files/document/nations-health-dollar-where-it-came-where-it-went.pdf

[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

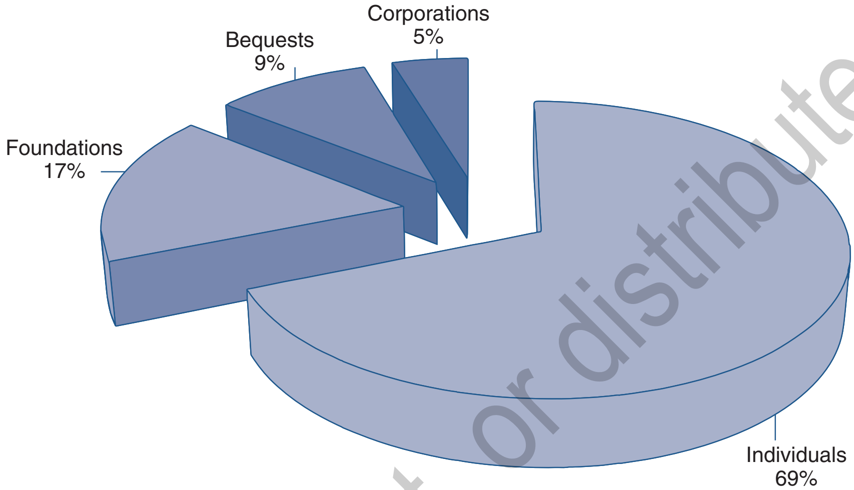
The not-for-profit sector in the United States is extremely large, with over 1.5 million different tax-exempt organizations registered with the US Internal Revenue Service (IRS) as of 2016. The largest single grouping is that of public charities, which number 1.1 million.[7] There is a tremendous range 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.

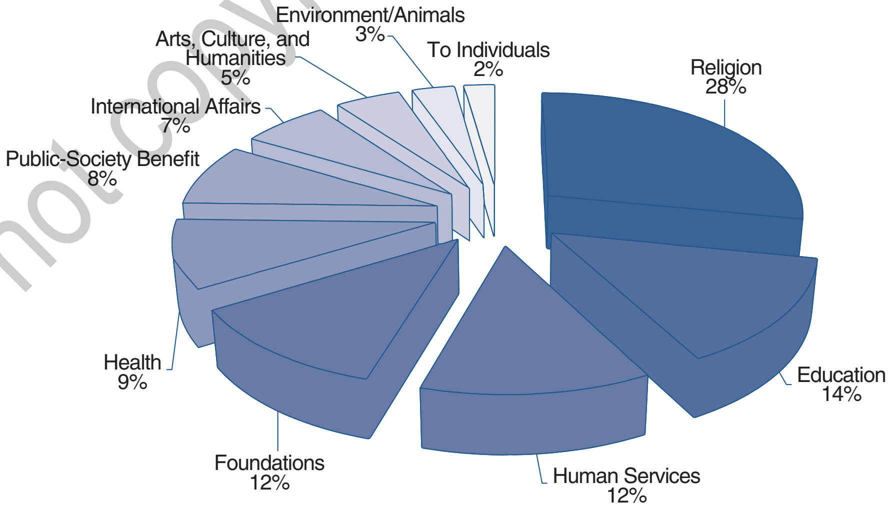
contributions, and in 2016 the average American household gave $2,240 to charity.[10] Contributions are spread across a wide variety of organizations, as seen in Figure 1-10. The greatest share of dollars contributed, 28 percent, went to religious organizations. Education, with 14 percent of the contributions, 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