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

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.

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. There may be one owner, known as a sole proprietor, or two or more partners, or—for the largest for-profit organizations—thousands of investors who collectively own millions of shares. 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 goals of the organization while maintaining a satisfactory financial situation. That is, they are mission driven rather than profit driven. 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 only 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 generate 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 greater than $5 trillion in the fiscal year 2024.[1] In addition, state and local government receipts exceed $4 trillion annually.[2] Spending on health care, meanwhile, now exceeds $4.5 trillion each year and is expected to total nearly $7 trillion by 2030.[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 U.S. 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. Included are both on- and off-budget items.

Table 1-1 ▪ Federal Receipts for the Fiscal Year Ending September 30, 2024 and 2025* (in Billions, On- and Off-budget)

Receipts	2024	2025
Individual Income Taxes	$2,503	$2,679
Social Insurance Taxes	1,721	1,897
Corporation Income Taxes	613	668
Other	245	241
Total	$5,082	$5,485

* Estimates

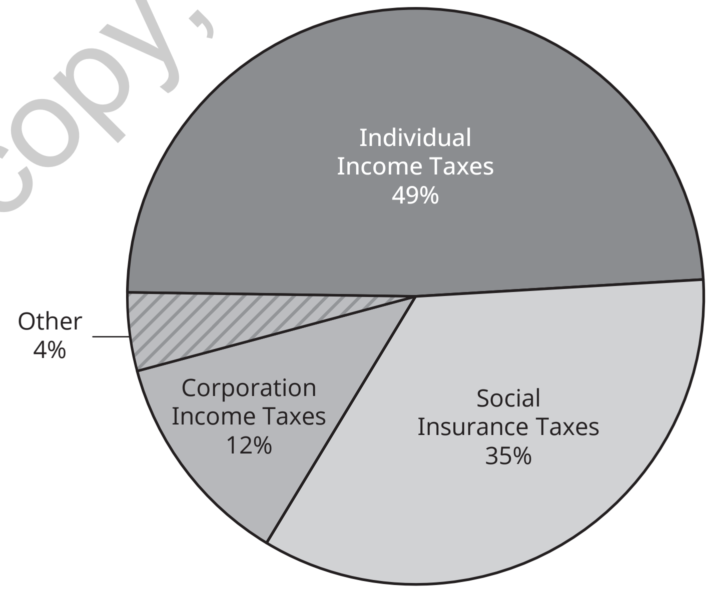
Source: Abstracted from "Table B–47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1959–2025," *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 466.

Per federal law, two entities are "off-budget" because their resource flows occur outside the government's annual discretionary budget cycle. They are the Social Security Trust Funds, which include Old-Age and Survivors Insurance and Disability Insurance, and the Postal Service Fund. In addition, many organizations—including the federal government—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 2025 fiscal year began on October 1, 2024, and ended on September 30, 2025.

Several types of receipts constitute federal government collections. These are individual income taxes, social insurance taxes (the majority of which are Social Security taxes), and corporation income taxes. Following the impact of the COVID-19 pandemic of 2020–2021, federal receipts have steadied relative to the precipitous declines following the onset of the pandemic. The relative proportions of the different categories of total federal receipts in 2024 and 2025 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).

In terms of spending, Social Security and national defense were the largest federal outlay categories during the second decade of this century. As a result of the pandemic, in 2020 the income security and other categories temporarily leapt ahead of Social Security and national defense. The sharp increases in 2020 on spending on income security included direct payments and food supplements to low-income or temporarily economically distressed individuals. Income security spending has since declined. 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.

Figure 1-1 ▪ Federal Receipts by Source (in Percentages) for the Fiscal Year Ending September 30, 2025 (Estimates)



Source: Derived from "Table B–47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1959–2025," *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 466.

Table 1-2 ▪ Federal Outlays for the Fiscal Years Ending September 30, 2024 and 2025* (in Billions, On- and Off-budget)

Outlays	2024	2025
Income Security	$761	$937
Social Security	1,458	1,550
Medicare	847	946
Health	858	889
National Defense	908	927
Net Interest	889	966
International Affairs	70	67
Other	1,151	986
Total	$6,941	$7,266

* Estimates

Source: Abstracted from "Table B–47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1959–2025," *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 466.

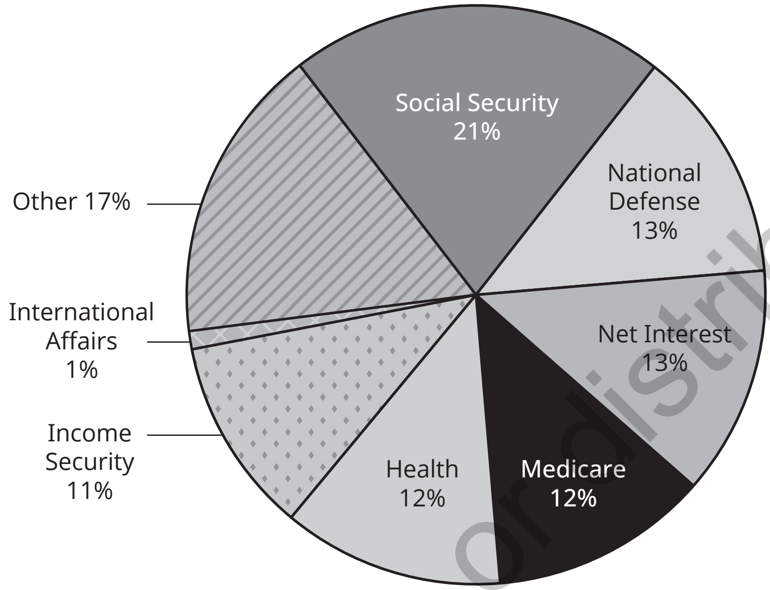
Prior to COVID-19, Social Security accounted for nearly a quarter of all federal outlays, making it the single largest category of spending by a wide margin. National defense (15%), Medicare (15%), health care (13%), and income security (12%) also represented large shares of federal spending. Post COVID-19 and macroeconomic factors such as inflation and rising interest rates, there has been a reshuffling of federal spending that resulted partly from changes in federal priorities and partly from the cost of borrowing to finance the government's response to COVID-19 as well as additional fiscal stimulus and an infrastructure bill that followed. As of 2024, relative to the pre-COVID-19 period, we can see dramatic shifts in Figure 1-2. Social Security spending dropped to 21% of federal government spending, whereas national defense and Medicare fell to 13% and 12%, respectively. Health care fell to 12%, and income security fell to 11%. Net interest is also a growing spending item for the federal government.

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. "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 1970–2025.

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

Figure 1-2 ▪ Federal Outlays by Category (in Percentages) for the Fiscal Year Ending September 30, 2024



Source: Derived from "Table B–47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1959–2025," *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 466.

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

	Fiscal Year Ending September 30						
	1970	1980	1990	2000	2010	2020	2025*
Total Receipts	$193	$517	$1,032	$2,025	$2,163	$3,421	$5,485
Total Outlays	196	591	1,253	1,789	3,457	6,554	7,266
Surplus or Deficit	$(3)	$(74)	$(221)	$236	$(1,294)	$(3,133)	$(1,781)
Gross Federal Debt	$381	$909	$3,206	$5,629	$13,529	$26,903	$37,096

* Estimates

Source: Abstracted from "Table B–45, Federal Receipts, Outlays, Surplus or Deficit, and Debt, Fiscal Years 1959–2025," *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 464.

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 one 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 twentieth-century high of 120% of the gross domestic product (GDP). That percentage fell over the decades following the war and reached a low of 33% in 1980, as seen in Figure 1-3. However, since 1980 the debt has risen substantially compared to the total U.S. economy as measured by the GDP with the only notable exception being around 2000, when the on- and off-budget accounts were in surplus (see Table 1-4 and Figure 1-3) and GDP grew at a previously unprecedented rate. The debt as a percent of GDP is estimated to be 126% as of 2025.

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 roles 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

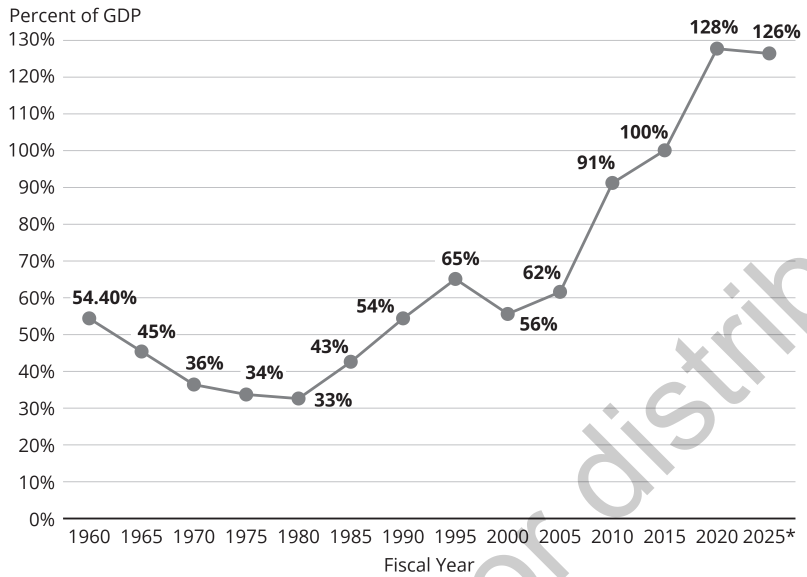
Table 1-4 ▪ Federal Debt and Gross Domestic Product—Selected Fiscal Years (Billions of Dollars)

	Fiscal Year Ending September 30							
	1960	1970	1980	1990	2000	2010	2019	2025*
Gross Federal Debt	291	381	909	3,206	5,629	13,529	22,670	37,096
Gross Domestic Product (GDP)	534	1,047	2,792	5,899	10,117	14,884	21,159	29,340

* Estimates

Source: Abstracted from "Table B–45, Federal Receipts, Outlays, Surplus or Deficit, and Debt, Fiscal Years 1959–2025," *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 464.

Figure 1-3 ▪ Federal Debt as a Percentage of GDP*



* Estimate

Source: Derived from "Table B–45, Federal Receipts, Outlays, Surplus or Deficit, and Debt, Fiscal Years 1959–2025," *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 464.

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 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 mentioned, 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 2007–2009 recession had an unusually severe impact on the federal government in that actual receipts for fiscal year 2009 were 22% lower than estimated in the 2008 edition of *The Economic Report of the President,* whereas outlays were more than 13% higher than estimated. High unemployment and stimulative tax cuts depressed individual and corporation income and payroll tax receipts, whereas 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 2007–2009 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 to 2020 is only exceeded by the 29% rise from 2005 to 2010, during the Great Recession of 2008. But it should be noted that by 2019, before COVID-19, the debt had already risen to a level of 107% of GDP.

STATE AND LOCAL GOVERNMENTS

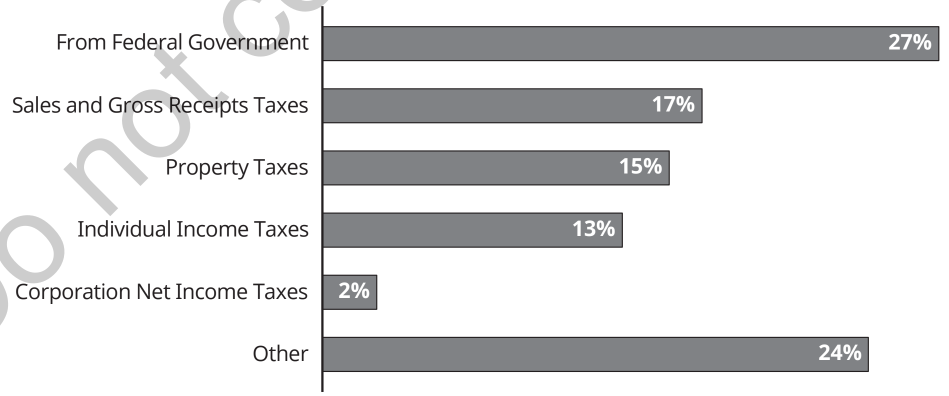
What are the sources and uses of money at the state and local government levels? Sales, property, and income taxes are the major forms of taxation used by state and local governments, as shown in Table 1-5 and Figure 1-4. Clearly, however, another significant source of funds for state and

Table 1-5 ▪ State and Local Government Receipts for the Fiscal Year Ending 2021 (in Billions)

Receipts	Amount
From Federal Government	$1,120
Sales and Gross Receipts Taxes	690
Property Taxes	630
Individual Income Taxes	545
Corporation Net Income Taxes	99
Other	992
Total	$4,076

Source: Abstracted from “Table B–50, State and Local Government Revenues and Expenditures, Fiscal Years 1958–2021,” *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 469.

Figure 1-4 ▪ State and Local Government Receipts for the Fiscal Year Ending 2021 (in Percentages)



Note: Percentages do not add up to 100% due to rounding.

Source: Derived from “Table B–50, State and Local Government Revenues and Expenditures, Fiscal Years 1958–2021,” *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 469.

local governments is the federal government. Other receipts include taxes on motor vehicles, 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. Some local governments are empowered by states to levy their own sales taxes, whereas many are not. Also, not all states have income taxes on individuals or on businesses, nor do all states have sales taxes.

Table 1-6 and Figure 1-5 show how state and local governments use their resources. The single largest object of expenditure is education, representing 31% of state and local outlays as of 2021, the most recent year for which the data are available. Public welfare and highways are other significant items for state and local governments. Note that 40% of spending is in the "Other" category. This is a reflection of the tremendous diversity in the states and localities of

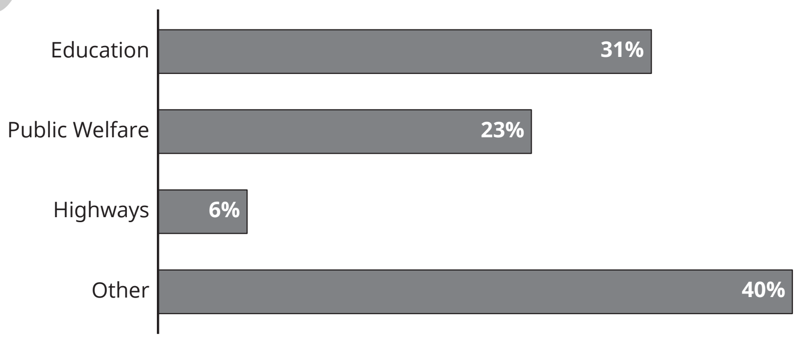
Table 1-6 ▪ State and Local Government Outlays for the Fiscal Year Ending 2021 (in Billions)

Outlays	Amount
Education	$1,143
Public Welfare	865
Highways	206
Other	1,470
Total	$3,685

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 1958–2021," *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 469.

Figure 1-5 ▪ State and Local Government Outlays for the Fiscal Year Ending 2021 (in Percentages)



Source: Derived from "Table B–50, State and Local Government Revenues and Expenditures, Fiscal Years 1958–2021," *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 469.

the country. Some have high costs for snow removal and subway systems. Others have no snow and little public transit. Some have large police departments, whereas others have minimal forces and so on. Common types of costs included in the "Other" category are libraries, police and fire protection, and parks.

As in the case of the federal government, COVID-19 had a substantial impact on state and local government spending. States incurred significant costs related to unemployment insurance claims, providing COVID-19 testing, providing health-care services, modifying air ventilation systems, creating safe school environments, and so on. Although the federal Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 offset some of these expenses, the extent to which it did varied. 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. Because state and local governments, unlike the federal government, generally are not allowed to run a deficit, the impact of COVID-19 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 twenty-first 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 restabilize between 2020 and 2030, after having considerably increased between 2010 and 2020, mostly as a result of the ACA in the early part of the decade and COVID-19 at the end of it.

State and local government funding of health care over the period from 2010 through the projection for 2030 grew substantially in absolute terms but only a minor amount as a percentage of national health expenditures, as demonstrated in Table 1-8.

Table 1-7 ▪ National Health Expenditures, Private versus Public, 2000, 2010, 2020, and 2030*

	2000		2010		2020		2030*	
	$ in Billions	Percent	$ in Billions	Percent	$ in Billions	Percent	$ in Billions	Percent
Private	878	64	1,432	55	2,041	49	3,518	52
Public (Federal, State, and Local)	488	36	1,157	45	2,115	51	3,286	48
Total	1,366	100	2,590	100	4,156	100	6,804	100

* Projected

Source: Actuals abstracted from "Table 5: National Health Expenditures by Type of Sponsor: Calendar Years 1987 to 2022." 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 2015–2031," 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/NationalHealthAccountsHistorical Group.

Table 1-8 ▪ National Health Expenditures, Private, Federal, and State and Local, 2000, 2010, 2020, and 2030*

	2000		2010		2020		2030*	
	$ in Billions	Percent	$ in Billions	Percent	$ in Billions	Percent	$ in Billions	Percent
Private	878	64	1,432	55	2,041	49	3,518	52
Federal	263	19	740	29	1,520	37	2,200	32
State and Local	225	16	418	16	595	14	1,086	16
Total	1,366	100	2,590	100	4,156	100	6,804	100

* Projected

Source: Actuals abstracted from "Table 5: National Health Expenditures by Type of Sponsor: Calendar Years 1987 to 2022." 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 2015–2031," 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/NationalHealthAccountsHistorical Group.

Although COVID-19 clearly stressed the health-care system, with hospitals treating hundreds of thousands, if not millions, of COVID-19 patients and at times running out of critical care beds, 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-19. 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 1-6. Medicare is a federal program; Medicaid and other public programs are paid for by federal, state, and local governments. Medicare and Medicaid make up more than 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.

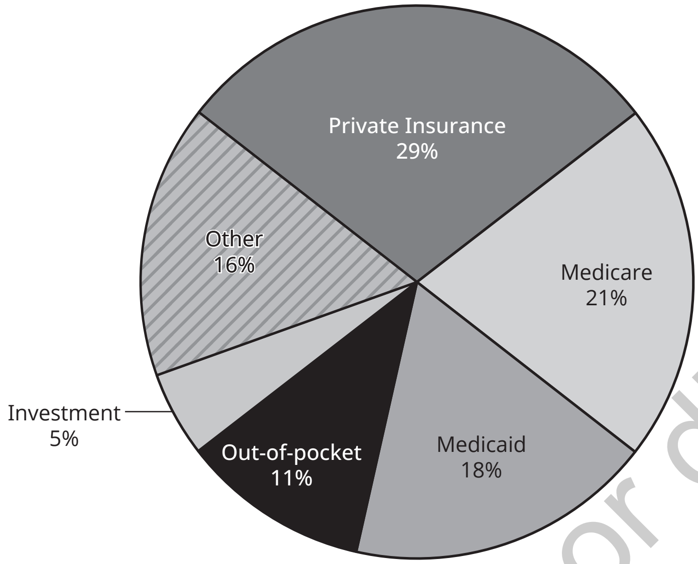
What is this money spent on? Figure 1-7 provides a breakdown of the total spending. Hospital care, at 30%, is the largest single cost driver. Physician services, nursing home care, and prescription drugs are also large objects of expenditure. Other spending includes dental, vision, research, construction, and other medical and nonmedical costs.

The Not-for-profit Sector

The not-for-profit sector in the United States is extremely large with about 1.8 million different tax-exempt organizations registered with the U.S. Internal Revenue Service (IRS) as of 2020.[7] The largest single grouping is that of public charities, which number just under 1.5 million as of 2022.[8] 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.

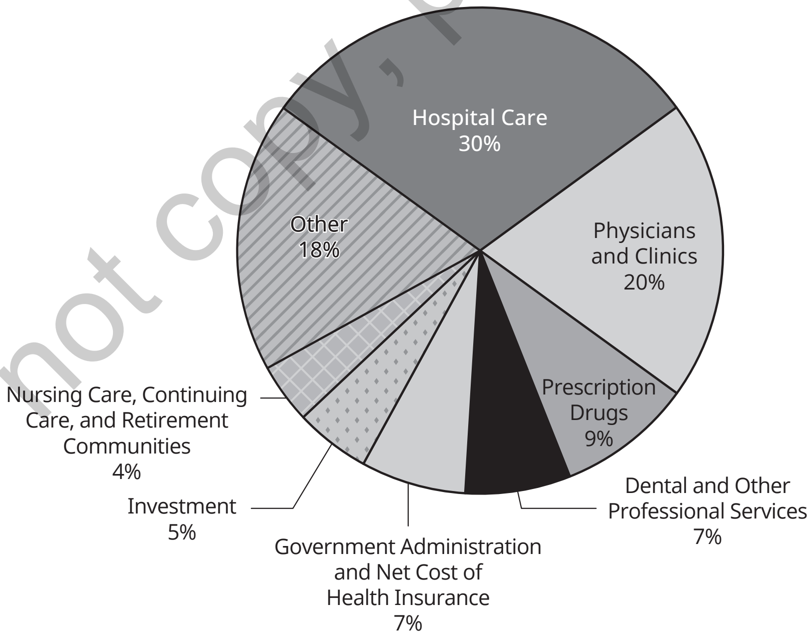
Although corporations and foundations make substantial contributions to the not-for-profit sector, the largest share of contributions, 64%, comes from individuals (see Figure 1-8). There was

Figure 1-6 ▪ The Nation's Health Dollar: Where It Came from, Calendar Year 2022



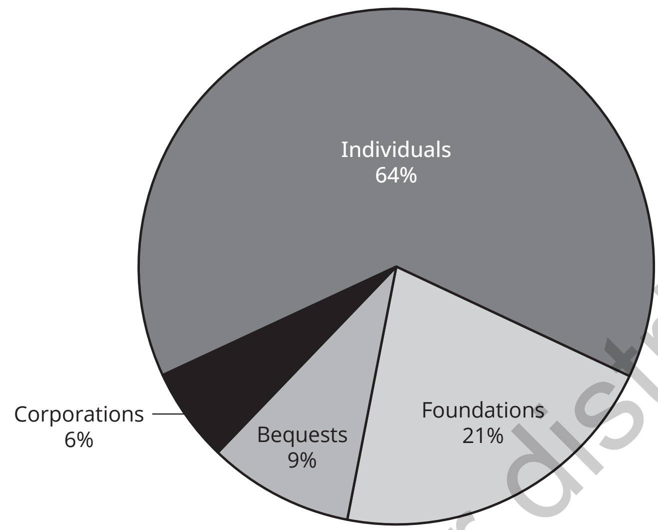
Source: "The Nation's Health Dollar ($4.5 Trillion), Calendar Year 2022: Where It Came From," Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group, https://www.cms.gov/files/document/nations-health-dollar-where-it-came-where-it-went.pdf.

Figure 1-7 ▪ The Nation's Health Dollar: Where It Went, Calendar Year 2022



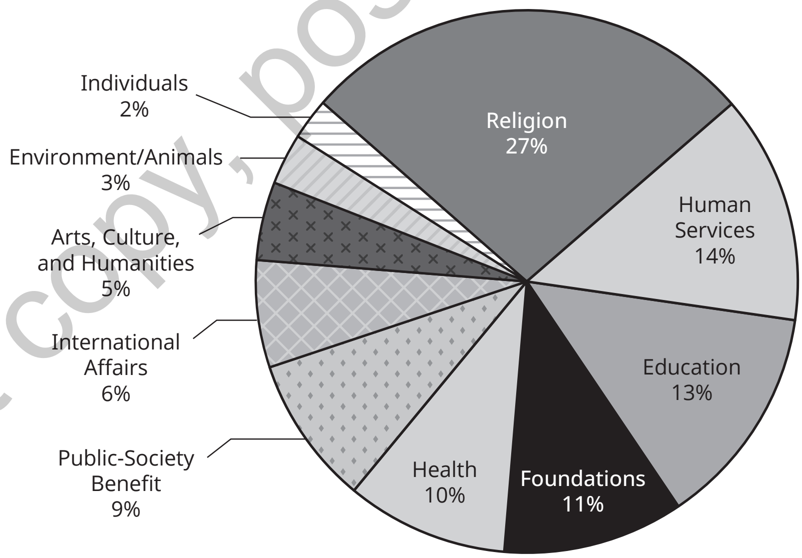
Source: "The Nation's Health Dollar ($4.5 Trillion), Calendar Year 2022: Where It Went," Centers for Medicare & Medicaid Services, Office of the Actuary, National Health Statistics Group, https://www.cms.gov/files/document/nations-health-dollar-where-it-came-where-it-went.pdf

Figure 1-8 ▪ Contributions: $499 Billion by Source of Contribution, 2022



Source: Giving USA: The Annual Report on Philanthropy for the Year 2022 (Chicago: Giving USA Foundation, 2023).

Figure 1-9 ▪ Contributions: $499 Billion by Type of Recipient Organization, 2022



Source: Giving USA: The Annual Report on Philanthropy for the Year 2022 (Chicago: Giving USA Foundation, 2023).

nearly $500 billion in allocated charitable giving in 2022.[9] In that year, estimated charitable giving by individuals and households was $319 billion.[10] Contributions are spread across a wide variety of organizations, as seen in Figure 1-9. The greatest share of dollars contributed, 27%, went to religious organizations. Human services, with 14% of the contributions, was a distant second. The not-for-profit sector is not totally, or even mostly, reliant on contributions, however.

In 2013 fees for services and goods from private sources accounted for 47.5% of public charities' revenues, whereas fees for services and goods from government sources accounted for 24.5%.[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 twenty-five to thirty 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 approximately only 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 Nongovernmental Organization Sector

The World Bank has defined nongovernmental organizations (NGOs) in World Bank Operation Directive 14.70 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." 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 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 twentieth 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 more than 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. Because 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. Because 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.

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, cooking, and getting meals to the homeless. But if they do that, there is a significant possibility that the organization will run out of money and 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 only breakfast and dinner or even only 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 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 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% per year, a piece of equipment that lasts five years will cost 15% 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 expand their services over time. This may be to reach out to more potential clients. Similarly, organizations want 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 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 museum operates a restaurant that is open to the general public (beyond 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 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 been appointed the executive director of Meals for the Homeless (Meals).

Sitting a few seats from Schwartz was Steve Netzer. He had worked in only 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 management roles in New York City. In a bit of a dramatic change, he had recently taken on the job of 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 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 2024 and even in pre-COVID-19 2019 were nearly $4.5 trillion annually. State and local government spending has exceeded $3.6 trillion. Spending on health care also exceeds $4 trillion each year. There were nearly $500 billion in charitable contributions in 2022.

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 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
creditors
debt
deficit
depreciation
effectiveness
efficiency
federal funds rate
finance
financial accounting
financial management
fiscal
gross federal debt
inventory
managerial accounting
national debt
net assets
not-for-profit (NFP)
off-budget
on-budget
payables
proprietary
receivables
surplus
tax-exempt
vendors

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 U.S. 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 only 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 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 and still be 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. In contrast, 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 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 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
charitable remainder trust

Notes

1. "Table B–47, Federal Receipts and Outlays, by Major Category, and Surplus or Deficit, Fiscal Years 1959–2025," *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 466.
2. "Table B–50, State and Local Government Revenues and Expenditures, Fiscal Years 1958–2021," *The Economic Report of the President, 2024* (Washington, D.C.: United States Government Printing Office, 2024), 469.
3. "Table 16: National Health Expenditures (NHE), Amounts and Average Annual Growth from Previous Years Shown, by Type of Sponsor, Selected Calendar Years 2015–2031," Centers 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.
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.
5. See James Howard, "Government Economic Projections: A Comparison between CBO and OMB Forecasts," *Public Budgeting and Finance* 7 (1987): 14–25.
6. George Miller, Corwin Rhyan, Ani Turner, and Katherine Hempstead, "COVID-19 Shocks the U.S. 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/.
7. *Research Report: Nonprofit Trends and Impacts 2021: National Findings on Donation Trends from 2015 through 2020, Diversity and Representation, and First-Year Impacts of the COVID-19 Pandemic* (The Urban Institute Center on Nonprofits and Philanthropy, 2021).
8. *Giving USA: The Annual Report on Philanthropy for the Year 2022* (Chicago: Giving USA Foundation, 2023).
9. *Giving USA: The Annual Report on Philanthropy for the Year 2022* (Chicago: Giving USA Foundation, 2023).
10. *Giving USA: The Annual Report on Philanthropy for the Year 2022* (Chicago: Giving USA Foundation, 2023).
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.
13. *Yearbook of International Organizations* (Brussels: Union of International Associations, n.d.), https://uia.org/yearbook
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.
15. Actually, the cost will increase by more than 15% because the impact of inflation compounds over time. Issues related to compounding are discussed in Chapter 5.

Chapter 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 let 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 the mission and describe the role of the mission for public service organizations;
- define the 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 the budget and explain how the budget provides a 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 sick or providing for the underserved. 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 many 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 ten 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 underserved in Middle City's public housing.
- Increase the fraction of the target population served from 20% to 60% within five 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

Whereas 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 three to five 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 only to 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 five 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 five 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 only 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% to 60% 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, they might consider a variety of approaches or tactics. Finally, they will formulate a long-range plan.

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 the number of units of service provided **(output)**. The number of meals served is important. But Meals's long-range plan should more broadly help it 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's 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's long-range plan may indicate that every meal must contain some protein, fat, carbohydrates, vegetables, and fruit. The organization will deem itself to be effective only 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% to 60%

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 three 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 and 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 and 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 and 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 2–5. 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 five 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 will be discussed in detail, 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 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 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 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. Because the program 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 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 thirty to fifty 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 Figure 2-1.

Figure 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			

"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 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 Figure 2-2.

The priest decided that thirty 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 Figure 2-2 shows the thirty teens. The value in line 6, column B, was then multiplied 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% 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 thirty 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 fifteen teens. With thirty teens anticipated, there would be two chaperones, and their airfare was included.

Figure 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)**

They would need hotels for fifteen 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 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.

2-1. Raise the price to $2,500.

2-2. Raise the number of teens to fifty.

2-3. Lower the airfare to $600.

2-4. Lower the hotel cost to $40 per person per night.

2-5. Change the chaperone salaries to zero.

2-6. 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 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."

Figure 2-3 ▪ Holy Land Trip—Special Purpose Budget: Final

	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**	**50**	**$2,500**	**$125,000**
7	**Less Uncollectibles**			**(3,750)**
8	**Net Charges**			**$121,250**
9	**Fundraising**	**50**	**250**	**12,500**
10	**Total Receipts**			**$133,750**
11				
12	**PROJECTED PAYMENTS**			
13	**Airfare**	**54**	**$ 600**	**$ 32,400**
14	**Hotels**	**50**	**600**	**30,000**
15	**Chaperone Salaries**	**4**	**0**	**0**
16	**Food**	**54**	**600**	**32,400**
17	**Admission Fees**	**54**	**125**	**6,750**
18	**Guide**	**1**	**3,000**	**3,000**
19	**Local Transport (Bus)**		**2,500**	**2,500**
20	**Entertainment**	**54**	**300**	**16,200**
21	**Other**	**54**	**200**	**10,800**
22	**Contingency Fund**			**2,500**
23	**Total Payments**			**$136,550**
24				
25	**Projected Surplus/(Deficit)**			**$ (2,800)**

"No," said the priest. "It doesn't. You see, I could tell that I would have to raise the price, and I know that I will probably only get twenty-five, or perhaps even twenty at the higher price. So I went over to my colleague, Father Stewart, in West Oak, and proposed that some of the teens from his parish come on the trip. Between the two parishes, we will be able to get forty to fifty teens at the higher price. I'm sure of it. And if I'm wrong, we can cancel the trip with no lost money."

"Well, that explains the price and the number of teens," Dwight responded. "What about the other changes?" Father Purtell answered, "First, I realized that with the additional teens we would need at least one more chaperone. I started thinking about whom we could hire and came up with the most wonderful idea. Several of our adult parishioners would love to take a trip to the Holy Land but cannot afford it. If I can pay the airfare, hotel, and all expenses, they would be more than happy to go as chaperones and not charge any salary. Father Stewart and I decided that two parent chaperones would come from each parish.

"When I went to the travel agent and mentioned fifty-four people, we got a substantial group discount on the flight and all admission charges as well. The hotel cost is more of a problem; we will have to have four teens to a room. The rooms all have two double beds. They can double up, or they can bring sleeping bags and take turns sleeping on the floor. I got our parish teen council involved, and it was their suggestion as a way to lower the cost per person. I found that getting more input in the budgeting process can open your eyes to things that you would not think of on your own. The four chaperones will share two rooms, which the travel agent will get for free when we book the rooms for the teens. We still have to rent only one bus for the whole group."

"Well, this seems good, but what if you get only forty teens instead of fifty?"

"Oh, I don't see that as a problem. The only reason that would occur is the price. Now, however, as you can see, we are projecting only a $2,800 deficit. And the deficit will only be that high if we need to use the entire $2,500 contingency fund. Our church is still willing to put up a $5,000 subsidy. I convinced Father Stewart to come up with a similar $5,000 subsidy from his parish. Even with the $2,800 deficit, we still have more than $7,000 available for financial aid for those teens who cannot afford the full amount. We will give scholarships.

"I must say, this has worked out splendidly. If I hadn't come to you, we might have done the program without planning the finances. We probably would have lost nearly $60,000. It would have been a disaster. And I'm glad you told me not to be discouraged by our first plan. When I saw the $59,500 deficit, my first reaction was to assume we couldn't do this wonderful program. But by having the budget, I had a plan to work with. You were so right to encourage me to reexamine each element of the plan to see what changes could be made. I was able to make changes and still accomplish the overall goal of getting teens over to the religious sites in the Holy Land. And the way the revised budget has come out, we will be able to send fifty teens instead of thirty!"

Lessons from the Case

This special purpose budget case study raises a number of important points. First, there is no magic to budgeting. Budgeting requires thought. Does the planned project fit with the organization's mission? Does it make sense to undertake this, given what other organizations are already doing? Can the organization afford to undertake the project? Budgeting requires estimating all the likely receipts and all the likely payments. The more facts that are available, the better. Knowing the airline fares, the hotel prices, the willingness of teens to live four to a room, and the admission rates at attractions leads to a more accurate budget. Inevitably, some assumptions must be made, such as the number of participants. The assumptions should be reasonable. A contingency plan should exist in case the assumptions do not all come out as anticipated. Moreover, the process is likely to require a number of preliminary drafts and revisions before a feasible plan is developed and accepted by all parties. Even so, things may not occur according to the budget. Once approved, efforts must be made to try to keep as closely to the plan as possible.

The Master Budget

Although some budgeting is done on an ad hoc basis, as in the case study discussed previously, most budgeting is done on a regular basis. The **master budget** incorporates and summarizes all the budget elements for the coming year. These elements provide the specific detail to accomplish both the routine, ongoing activities of the organization and the coming year's portion of the long-range plan. By incorporating service volume, prices, costs, cash flow, and capital spending, the master budget becomes the plan for everything the organization will be doing during the coming year. It is prepared each year.

The main elements of the master budget, sometimes called the comprehensive budget, are the **operating budget** and the **financial budget**. The operating budget presents a plan for revenues and expenses for the **fiscal year**. It poses the question: Do we expect to earn more resources during the budget period than we expect to use during the period? The financial budget includes a **cash budget** and a **capital budget**. The cash budget focuses primarily on the coming year. It asks the question: Do we expect to receive enough money (from clients, residents, donors, etc.) during the budget period to make the payments (for salaries, supplies, rent, etc.) that we expect to make during that time? The capital budget plans for cash receipts and payments specifically for resources that will provide service for a period longer than only the coming year. Capital budgeting is discussed in Chapter 5.

Operating budgets estimate organizations' types of revenues and expenses, whereas cash budgets estimate their cash receipts or payments. Payments are also referred to as disbursements or outlays. Governments, meanwhile, tend to refer to expenses as **expenditures**. Nongovernmental organizations may use the term "expenditures" synonymously with "cash payments." For example, for the HOS, the major sources of revenue in the operating budget may be patient revenue, donations, investment income, gift shop sales, and cafeteria sales. For the town of Millbridge, revenues would likely consist of real estate taxes, state aid, sewer taxes, and user fees. Meals is likely to have items such as donations, grants, and government aid. For all three types of organizations, typical expenses (or expenditures) would include salaries, supplies, and rent among others.

Capital budgets focus on the acquisition of long-term resources. Expenses such as salaries, supplies, and rent would not appear in a capital budget. Instead, one might see a listing of pieces of equipment and/or buildings. Revenues are often not included in the capital budget, which focuses on the cost of, and the justification for, the acquisition. However, revenue flows that result from acquiring the items in the capital budget are considered in the capital budgeting process. Also, if old equipment or buildings are sold as they are replaced by new equipment and buildings, the revenues from the proceeds of those sales may be included in the capital budget.

The Operating Budget

The operating budget is a plan for expected revenues and expenses. For-profit organizations generally earn revenues in exchange for providing goods and services. Not-for-profit organizations may earn revenues in a similar fashion and may also receive support from contributions or grants. Governments may earn revenues from the sale of goods and services, but primarily they are entitled by law to collect tax revenues to be used to provide services. Expenses are the resources that the organization uses or consumes in carrying out its activities. There is often a gap between when an organization provides goods or services and when it receives cash payments for providing those goods or services. Similarly, there is often a gap between when an organization consumes resources in the course of providing goods or services and when it makes cash payments for those resources.

Revenues and Other Support. When patients are treated at HOS, they receive bills for the care provided. Suppose that a patient is billed $5,000 for the care they have received. HOS may generate $5,000 in revenue by merely providing the care and billing the patient. Alternatively, HOS may generate the revenue only after it receives payment for the care that it provided. It depends on HOS's accounting system, and this is discussed further as follows.

The basic approach to developing an operating budget is not substantially different from the approach taken in preparing the special purpose budget. One must consider all possible sources of revenue or other **support**; support includes cash donations and other contributions that are in support of an organization but do not directly derive from that organization's delivery of goods and services. Revenues can be calculated by predicting the volume of goods or services to be provided and their unit price. Multiplying the price per unit by the volume of units provides the organization with an estimate of its revenues.

In the case of governments, revenues are often calculated by multiplying tax rates by the tax base. For example, assume that in Millbridge the real estate has a total assessed value of $200 million. That amount is referred to as the town's tax base. The town's tax rate might be stated as $50 per $1,000 of assessed value. This means that the taxpayer would have to pay $50 for every $1,000 of assessed property value. Therefore, if the taxpayer's house is assessed at $300,000, the taxes would be $15,000. For the town as a whole, the taxes would be $10 million ($200 million tax base × [$50 ÷ $1,000]).

When revenues are listed in the operating budget, they are generally separated by source. Suppose that the state gives the town of Millbridge $2 million in aid for use in the school system. The town charges a sewer tax, which is $80 per year for each residential property. There are 10,000 homes in the town, yielding a total sewer tax of $800,000. Finally, the town charges users of the town pool, golf course, and tennis courts varying fees. Based on the number of users of each facility and the prices charged, the town expects to bring in a total of $500,000 in user fees. In preparing its budget for the coming year, the town would likely have a listing such as the following in Table 2-1:

Table 2-1

Town of Millbridge Operating Budget Projected Revenues	
Real Estate Taxes	$10,000,000
State Aid	2,000,000
Sewer Tax	800,000
Recreation User Fees	500,000
Total Revenues	$13,300,000

There is often great latitude in the budgeting process. Except in governmental situations, where laws may dictate the format and content of budgets, organizations can develop their budgets in any way that the managers believe will be most useful. Therefore, unless prohibited by law, Millbridge's revenue budget might be grouped as taxes and other sources, as follows in Table 2-2:

Table 2-2

Taxes	$10,800,000
Other Revenues	2,500,000
Total Revenues	$13,300,000

In this format, real estate and sewer taxes have been grouped together. Other groupings are possible as well.

In addition to having a revenue budget that shows the revenues by each major source, there should be detailed supporting schedules backing up each line on a budget. This is true for an expense budget as well. These schedules provide the information that explains the derivation of each number that appears on the budget. For example, each piece of property and the assessed value of that property should be listed. These supporting schedules are not a part of the finished budget. However, they provide important backup information, especially if questions arise before the budget is adopted.

In preparing the revenue budget, it is extremely important to consider all possible sources of revenue or support. In addition to taxes or charges for services, these sources might include ancillary sources such as gift shops or restaurants, endowment income, gifts, or grants.

In predicting revenue for the coming year, managers should consider many issues. Managers need to be concerned not only with what they might want to do but also with other factors such as the economy, inflation, growth, employment, and interest rates. In some cases, formalized forecasting of variables is needed to arrive at a sound budget. For example, Millbridge's town manager, Dwight Ives, would likely realize that he has to undertake a commonsense review of the likely impact of the economic environment on the organization. He would plan to use a variety of forecasting approaches to predict variables that would affect the town's revenues. (Forecasting is discussed in Chapter 3.)

Some variables are uncontrollable. However, not everything is outside of the control of the manager. For example, managers often have to make investment decisions. If the organization has money that it will not be using right away, it must decide how to invest that money. Managers can decide to invest in safe investments with low rates of return or can seek out somewhat riskier investments that have higher possible returns.

Also, things like user fees are subject to some degree of control. Suppose that last year the town sold 3,000 season pool passes at $100 each. Because the town's population is fairly stable, the forecast is for similar results in the coming year. However, that represents a forecast of what will happen rather than a budget. Before the budget can be finalized, it is necessary to consider factors such as the impact of raising or lowering the price, competition from new county facilities, and the potential impact of making improvements at the town's pool.

Although it is true that not everything is out of the manager's control, neither can managers do whatever they want. In preparing the previously mentioned revenue budget, Ives made assumptions of modest increases in taxes and user fees. He knows, however, that if the expense budget is higher than the revenue budget, he will need larger increases in taxes. Such increases will be politically difficult to attain. At that point, there will be difficult negotiations with the mayor and town council over whether to increase taxes or cut services.

Expenses. Some organizations budget revenues before expenses, and some do the opposite. The order is not critical because it is likely to be necessary to make revisions to arrive at an acceptable budget in any case. In many situations, the revenue and expense budgets will be prepared simultaneously. For example, government agencies may be preparing their expenditure budgets individually, whereas the central government administration is estimating total revenues that will be available.

Dwight Ives's first attempt at developing a budget for expenses—here, they are expenditures—considered all the costs currently incurred as well as additional expenditures required to incorporate elements of the town's long-range plan. Aggregating all the individual costs required to operate the town resulted in the following budget for expenditures in Table 2-3:

Table 2-3

Town of Millbridge Operating Budget Projected Expenditures	
Salaries	$10,800,000
Utilities	1,800,000
Supplies	1,500,000
Total Expenditures	$ 14,100,000

Surplus or Deficit. The budgeted expenses or expenditures of the organization are subtracted from the budgeted revenues to determine whether the plan projects a surplus or deficit for the coming year. In some instances, a loss may be acceptable. Organizations with large amounts of accumulated profits from earlier years may be willing to lose money in other years. In other cases, losses may be inevitable. In no case should an organization be indifferent. Unfortunately, Millbridge does not have a balanced operating budget, as can be seen in Table 2-4.

Table 2-4

Town of Millbridge Operating Budget Projected Revenues and Expenditures	
Revenues	
Real Estate Taxes	$10,000,000
State Aid	2,000,000
Sewer Tax	800,000
Recreation User Fees	500,000
Total Revenues	$13,300,000
Expenditures	
Salaries	$10,800,000
Utilities	1,800,000
Supplies	1,500,000
Total Expenditures	$14,100,000
Deficit	$(800,000)

In general, the town council would not legally be allowed to adopt a budget containing a deficit. Ives would have to go back to each element of the operating budget, finding additional revenues and/or reducing expenditures. This would be similar to the process that Ives required Father Purtell to undertake to revise the Holy Land trip budget. It would be helpful if Ives could look at the budgeted results for each main activity of the town. For example, is the town swimming pool expected to make money or lose money? Such breakdowns of budget information into more useful formats are discussed in Chapter 3.

The surplus or deficit reported in the operating budget relates only to the period covered by that budget. Each period's surplus or deficit is determined based on the revenues and expenses of that period. The budgets presented in this chapter are simplified. Table 2-5 presents a somewhat more realistic budget for one department in the hypothetical HOS.

Table 2-5 ▪ Department Budget

Hospital for Ordinary Surgery Laboratory Department Operating Budget	
Account	**Budget**
311. Revenues	
010 Routine	$31,244,410
020 Other	27,590
Total Revenues	$31,272,000
411. Personnel Services (PS)	
010 Salaries—Regular	$24,230,881
020 Salaries—Per Diem	112,845
030 Salaries—Overtime	140,128
050 FICA	1,575,007
060 Health Insurance	862,125
070 Pension	1,211,544
090 Other	217,228
Total PS Expenses	$28,349,758
611. Other Than Personnel Services (OTPS)	
010 Laboratory Supplies	$1,841,692
020 Office Supplies	10,097
030 Forms	32,111
050 Equipment	91,553
060 Seminars/Meetings	4,163
070 Books	1,145
080 Equipment Rental	8,385
090 Miscellaneous	2,388
Total OTPS Expenses	$1,991,534
911. Interdepartmental Expenses	
010 Central Supply	$77,828
020 Pharmacy	9,527
030 Laundry	16,046
040 Maintenance	28,977
060 Telephone	15,962
070 Photocopy	2,124
090 Miscellaneous	4,165
Total Interdepartment Expenses	$154,629
Total Expenditures	$30,495,921
Excess of Revenues Over Expenses	$776,079

Cash versus Accrual Accounting. In some organizations, revenues are acknowledged, or recognized, only when they are received in cash. In those cases, expenses are recognized only when they have been paid in cash. These are the **recognition** rules of the **cash basis** of accounting. For example, suppose that HOS treats a patient in December 2026 and issues a bill to the patient upon discharge on December 12, 2026. HOS receives payment for the care from the patient's insurance company on January 18, 2027. Assuming HOS ends its fiscal, or accounting, year on December 31 of each year, when should it recognize the revenue from the patient? On the cash basis of accounting, the revenue is recognized in 2027. That is, HOS would project those revenues in its fiscal year (FY) 2027 budget rather than in its FY 2026 budget.

Many argue that preparing an operating budget based on cash inflows and outflows may result in a misleading depiction of an organization's results from its financial operations. In the case of HOS, the costs of caring for the patient (personnel, supplies, etc.) would be recognized as expenses in 2026 if HOS paid or expected to pay them in 2026. The related revenues, however, would be recognized in 2027 if HOS does not expect to receive them in cash until 2027. Across a large number of patients, it might seem that the organization had a deficit in 2026, even if the revenues that will ultimately be collected for those patients in 2027 will exceed the expenses. The operating budget for 2026 would provide an unduly pessimistic view of the expected financial results from treating patients.

It is generally considered better practice for organizations to have a **matching** of revenues and expenses. A matching means that for a given unit of service provided, the revenues arising from providing that service and the expenses incurred in providing that service are both recognized in the same fiscal period. In that way, the organization will be able to determine if the provision of specific services results in a profit or loss.

Should the money that HOS is entitled to receive for providing care be considered revenue in the year care is provided or the year payment is received? If the revenue is recognized in the year the service is or will be provided, the organization is using the **accrual basis** of accounting. As noted earlier, if revenue is recognized in the year the cash is or will be received, the organization is using the cash basis of accounting.

The choice of whether to use a cash or accrual accounting system is an often-debated topic. Cash accounting is easier. But it does not do a good job of letting managers understand whether the organization's activities are profitable. Accrual accounting is more difficult, but it provides a matching of revenues and expenses. When operating budgets are prepared using the accrual basis of accounting, the organization accrues, or anticipates, the eventual receipt of money once the service has been provided. When the organization provides its goods or services, it has earned its revenue. Thus, in the 2026 operating budget, HOS will include all amounts it expects to earn in 2026, even if they will not be received in cash by the end of 2026.[2]

The accrual approach applies not only to the sale of goods or services but to charitable support as well. Suppose that the director of the Millbridge Ballet Company convinces the Millbridge Town Council to provide the not-for-profit organization with an annual subsidy of $10,000 as long as it gives at least twenty performances a year. If it uses the accrual basis of accounting, Millbridge Ballet would recognize the town support if it gives twenty performances in the year, even if the town does not make the payment before the end of the year.

By the same token, under an accrual approach to preparing an operating budget, expenses are recognized in the year in which resources are consumed. If supplies are bought and used this year, they are considered to be a cost, or expense, in the operating budget, even if the supplier is not paid until the following year.

The accounting profession strongly endorses accrual accounting. Accrual accounting allows the organization to compare the money that it is entitled to receive for this year's activities to the cost of resources used carrying out those activities. There is less room for manipulation than in a system based on cash. Imagine an operating budget that used cash receipts and disbursements. If one wanted to look especially poor, it is possible to accelerate payments and postpone collections. If one wanted to look like the year was especially good, the reverse could be done. By contrast, with accrual accounting the revenues and expenses are associated with a year based on actual activity and are much less subject to manipulation.

To better understand the implications of cash versus accrual, consider the following example. Tricky Hospital provides $100 million of care each year and always eventually collects all that money. Tricky consumes $100 million of resources each year. In 2024 Tricky's board of directors wished to look especially needy so that they could encourage a donor to make a large gift. Tricky paid for all its current consumption and even prepaid for supplies that would not be received and used until sometime in 2025. Tricky also made no efforts to encourage rapid payment by its patients or the patients' insurers for the care Tricky provided in 2024. As a result, Tricky collected only $90 million in cash but made payments of $110 million.

In 2026, however, Tricky wanted to convince a bank that it was particularly financially solid so that the bank would lend Tricky $300 million for a major expansion program. Tricky again provided $100 million of care and consumed $100 million of resources. However, in 2026 Tricky worked hard to collect as much cash as possible from patients and insurers. Meanwhile, it kept its employees and suppliers waiting for their payments until early in 2027. It wound up collecting $110 million (partly from care provided in 2025 and the rest from care provided in 2026) and paying $90 million in cash during 2026.

In both years, the amount charged for services provided was the same, and the cost of resources consumed was the same. However, consider the financial results that would be reported on a cash basis in contrast to an accrual basis, as shown in Table 2-6:

Table 2-6

	Cash Basis		Accrual Basis	
	2024	2026	2024	2026
Revenues	$90,000,000	$110,000,000	$100,000,000	$100,000,000
Expenses	110,000,000	90,000,000	100,000,000	100,000,000
Profit or (Loss)	$(20,000,000)	$20,000,000	$0	$0

Note that the accrual system is clearly not as subject to manipulation as the cash basis approach. When accrual accounting is used, the operating budget gives a good idea of how profitable the organization can expect to be based on its activities for a particular period. However, it does not give an accurate idea of how much cash it will have. Tricky Hospital really did use more cash in 2024 than it collected. Because cash may be received at different times than the revenues and expenses are reported on an accrual basis, it is necessary to have a cash budget as well as an operating budget to be sure enough cash is available to meet obligations as they come due.

The Financial Budget

The financial budget has two primary components: the cash budget and the capital budget. The cash budget plans for the cash receipts and disbursements of the organization. The capital budget plans for the acquisition of long-term resources, such as buildings and equipment.

The Cash Budget. The cash budget is a plan for expected cash receipts and payments. It is identical to the operating budget for organizations that use the cash basis of accounting. For organizations using the accrual basis of accounting, the cash budget provides vital additional information. It helps managers know when there will be cash available for investment and when a shortage of cash is expected. This information allows the organization either to arrange for sources of cash (such as a loan from the bank) to alleviate an expected shortfall or to change the organization's planned revenues and expenses to avoid the shortage.

In the case of HOS, the cash budget estimates the amount that will be paid during the year for expenses and the amount that will be collected during the year for patient treatment. Any other sources and uses of cash would also be included in the cash budget. The general format for cash budgets is as follows in Table 2-7:

Table 2-7 ▪ Cash Budget Format
Beginning Cash Balance
+ Cash Receipts
= Available Cash
− Cash Payments
= Subtotal
+/− Cash from Borrowing/(Lending)
+/− Cash from Sale/(Purchase) of Investments
= Ending Cash Balance

Note that cash budgets are similar to personal checking accounts. The amount of cash we have at the end of one period is still available at the beginning of the next period. So the beginning cash balance for any cash budget is identical to the ending cash balance from the previous period.

This budget is generally prepared for the coming year. However, it is also important to have more frequent cash projections. For example, within the annual cash budget, there may be monthly cash budgets. Just knowing that cash receipts are sufficient to cover cash payments for the year may be inadequate. It is helpful to know if the organization expects to have enough cash to pay its bills each month.

For example, the town of Millbridge has variable cash flows. The town issues bills for its real estate taxes on a quarterly basis, its user fees mostly during the spring and early summer, its sewer taxes once a year near the beginning of the year, and its state aid once a year near the middle of the year. Even if annual cash receipts are enough to cover payments, Millbridge might need to borrow money to get through certain times of the year when cash receipts are low.

The cash flow is complicated by the fact that not only are billings not constant throughout the year, but different sources of money arrive with differing payment lags. Most people pay their taxes promptly because the town charges a high interest rate on late payments. By contrast, the state does not make its payments until near the end of the year. This allows the state to have the political advantage of being able to show aid to the municipalities and also keep the money in the state account earning interest until the last possible day.

Let's consider an example of how a cash budget might work. For this example, assume that Meals has a fiscal year of January through December. It had $15,000 cash at the end of last year and had no investments or outstanding loans as of the end of the year. If an organization finishes a year with $15,000 cash, that cash will still be available at the beginning of the following year. Meals expects to earn $10,000 a month from the city next year. However, this is a new contract, and the city pays each month with a one-month delay (also known as a lag), so the payment for January will not be received until February, and so on. Meals expects to receive $60,000 in contributions for the coming year. However, most of them will be earned and received in December, when Meals holds its annual fundraising gala. Meals expects to receive $3,000 of the $60,000 total contributions every month from January through November, and the remaining $27,000 in December. It also expects to receive $5,000 every month from other sources. Despite the fairly wide fluctuations in the receipt of contributions, Meals provides its services evenly throughout the year. Meals pays $1,000 in rent every month. It expects to pay its staff $11,000 every month. Its supplies are increasing in cost due to inflation. In the last month of last year, it used $4,500 of supplies, but it expects that cost to rise $100 each month. Meals pays its suppliers with a one-month lag, so the $4,500 for December will be paid in the first month of the coming year. Other expenses that are paid in cash every month total $3,000. Meals wants to be sure to begin every month after January with $4,000 cash available. If it has more or less than that amount at the end of a month, it invests or borrows money. The organization's plan is to pay back any outstanding loan balance in December, when it receives the bulk of its contributions. The monthly cash budget for the first quarter of the coming year would be as follows in Table 2-8:

Table 2-8

Meals for the Homeless Cash Budget				
	For the First Three Months of Next Year			
	January	February	March	Total
Beginning Balance	$15,000	$4,000	$4,000	$15,000
Cash Receipts				
City		10,000	10,000	20,000
Donations	3,000	3,000	3,000	9,000
Other	5,000	5,000	5,000	15,000
Total Available Cash	$23,000	$22,000	$22,000	$59,000
Less Cash Payments				
Labor	$11,000	$11,000	$11,000	$33,000
Rent	1,000	1,000	1,000	3,000
Supplies	4,500	4,600	4,700	13,800
Other	3,000	3,000	3,000	9,000
Total Cash Payments	$19,500	$19,600	$19,700	$58,800
Subtotal	$3,500	$2,400	$2,300	$200
Borrowing/(Repaying or Investing)	500	1,600	1,700	3,800
Ending Cash Balance	$4,000	$4,000	$4,000	$4,000

The cash budget is generally read one column at a time to find out what will happen in each time period or by looking at rows to get information about a specific **line item**, such as donations or rent. For example, one might start to read this budget by first looking at January. Notice that the January column starts with a beginning cash balance of $15,000. That would be identical to the amount of cash that we had at the end of the preceding year. Reading down the January column, we see that no cash is expected to be received from the city in January. The only expected receipts that month are from donations and other sources. The starting cash balance plus cash receipts in January provide available cash of $23,000 for that month. Payments are made for labor, rent, supplies, and other. Note that the January payment for supplies is the $4,500 for the supplies used during the previous month but not paid until January. All four of these cash payment items total $19,500 in January. That total of cash payments is subtracted from the $23,000 of available cash to arrive at a $3,500 subtotal before borrowing or investing. Because Meals wants to start February with $4,000 of cash on hand, it will have to borrow $500 at the end of January.

The $4,000 ending cash balance for January becomes the beginning balance in the February column. Looking at the February column of the cash budget, we see that during February Meals expects to receive $10,000 from the city as well as the $3,000 donation and other cash inflows of $5,000. Cash payments are the same as January except for the increasing supply payments. Despite the cash receipt from the city, payments once again are expected to exceed receipts, and Meals expects to have to borrow $1,600 to end February and begin March with $4,000 of cash.

Notice, in the total column for the three months, that the first and last rows are not summed across the columns. That is, the starting cash balance in the total column is simply the $15,000 Meals begins the year with. And the ending cash balance in the total column is the $4,000 that Meals has at the end of March. But we can add the cash receipts, cash payments, and borrowing values across all columns to get the totals for the three-month period. In the Totals column, the starting cash balance of $15,000 plus all the cash receipts in total for the three months, less all the cash payments in total for the three months, equals a $200 subtotal for the three months. (Note that this subtotal is arrived at by adding down the total column, not across the subtotal row.) Combined with the $3,800 total amount that has been borrowed over the three months, we get the $4,000 cash value at the end of the quarter. Notice that Meals had to borrow money every month in the quarter, but it appears that if things keep going as they are, the $27,000 of expected cash receipts from donations in December should be enough to allow for repayment of the total outstanding loans by the end of the year. Being able to demonstrate in a cash budget that you know when you will be able to repay a loan increases the likelihood of obtaining a loan.

To further reinforce the differences between cash and accrual accounting, Meals' operating budget on an accrual basis for the same period would be presented as in Table 2-9.

One distinction is immediately obvious: There are no opening balances, subtotals, or ending balances. Operating budgets prepared on the accrual basis are for planning an organization's profitability—that is, the organization's ability to generate resources above and beyond the value of the resources it uses or consumes in providing goods and services. Organizations do not begin a fiscal year with last year's profitability, although they do begin with last year's cash on hand. Also, amounts borrowed, repaid, and invested do not appear on an operating budget. When an organization borrows cash, it has not earned revenue. Similarly, when an organization repays cash it has borrowed, it has not consumed a resource—it has merely returned another organization's or person's property—nor has it consumed a resource when it invests cash.

A final distinction is that operating budgets do not reflect lags or leads in cash receipts or payments. Whereas "lags" are delays in cash receipts or payments (i.e., amounts are received or paid after a good has been consumed or a service has been provided), "leads" mean amounts have been received or paid in advance of consuming goods or providing services. Therefore, Meals plans for $10,000 in revenues from the city each month despite the one-month lag in the cash receipt. As for supplies, on the accrual basis Meals budgets the value of the supplies it will consume each month, not the cash payments it will make on those supplies, which reflect a one-month lag. Ignoring lags or leads, in combination with not considering amounts borrowed,

Table 2-9

Meals for the Homeless Operating Budget	For the First Three Months of Next Year			
	January	February	March	Total
Revenues				
City	$10,000	$10,000	$10,000	$30,000
Donations	3,000	3,000	3,000	9,000
Other	5,000	5,000	5,000	15,000
Total revenues	$18,000	$18,000	$18,000	$54,000
Expenses				
Labor	$11,000	$11,000	$11,000	$33,000
Rent	1,000	1,000	1,000	3,000
Supplies	4,600	4,700	4,800	14,100
Other	3,000	3,000	3,000	9,000
Total Expenses	$19,600	$19,700	$19,800	$59,100
Profit or (Loss)	$(1,600)	$(1,700)	$(1,800)	$(5,100)

yields a result that varies from the organization's cash budget. Although Meals will have a positive cash balance on the cash basis, for the first quarter of next year, it will have a small but increasing deficit on the accrual basis. Nonetheless, it appears the $27,000 Meals expects to earn via its December gala will be sufficient to ensure a profitable year.

The Capital Budget. Another type of budget is a capital budget. A capital budget is a plan for acquisitions of capital assets. **Capital assets** are resources that have lifetimes that extend beyond the year in which they are acquired. This typically includes buildings and equipment.

One reason the capital budget is used relates to the issue of accrual accounting. If Meals buys a delivery truck with a five-year life, it would be inappropriate to charge the entire cost of the truck to the coming year. Suppose that a delivery truck costs $40,000. Even if Meals will pay $40,000 cash for the truck next year, and therefore it will be a $40,000 reduction in the cash budget, Meals will not fully use up the truck in one year. Part of the truck will be used in future periods. It would not be reasonable to charge the entire $40,000 cost of the truck as an expense in its first year. Organizations that use accrual accounting would spread the $40,000 cost of the truck out over the years it is used, charging a portion as an expense each year. Thus, the full cost of the truck will be included in the capital budget, but only a one-year portion of the cost of the truck will be included as an expense, called **depreciation expense**, in the operating budget each year.

For example, we expect the $40,000 delivery truck to last for five years. At the end of five years, assume that we will dispose of it. It will have no value at that point and cannot be sold for anything. We simply divide the $40,000 cost by the five-year expected lifetime. The resulting $8,000 ($40,000 ÷ 5 years = $8,000) per year is the amount of expense that we will record each year as we use the truck. That expense is depreciation expense. Depreciation can become complicated. There are issues concerning how we determine the lifetime, the amount the asset can be sold for at the end of its lifetime, and whether it is reasonable to assume that an equal amount of the asset is used up each year. Depreciation is discussed further in Chapter 10 and Appendix 10-B.

Most organizations that do not use accrual accounting do not use a true cash basis. Rather, they use a **modified cash basis**. Under such a modified cash approach, routine revenues and expenses are recognized on a cash basis, but capital assets, such as buildings and equipment, are recognized as expenses gradually over the years they are used rather than all in the year the organization pays for them.

Capital budgets are closely coordinated with the long-range plan. Often, to carry out that long-range plan, it is necessary to make major investments in buildings and equipment that will have relatively little initial benefit. However, the long-range plan looks far enough into the future to recognize the long-term benefit that may come from that current investment. Chapter 5 examines financial management methods used to evaluate the financial impact on the organization of capital asset acquisitions.

Capital acquisitions are evaluated in a separate budget from the operating budget for a number of reasons. First, as noted, it does not make sense to include the full cost of the capital asset in the operating budget for one year because it is not fully used up in that year.

A second reason for having a separate capital budget is that capital assets often represent large costs for major pieces of equipment and buildings. A poor decision could be costly, so it is worthwhile to give the decision focused attention. Because capital items will last for a number of years, the organization is making a long-term commitment. If it makes an error in selection, it will be committed to that error for a long time. In the case of governments, capital budgets are often mandated by law or regulation.

A third reason that capital assets receive special attention is related to their financing. Because capital items are often expensive, the organization often has to make special arrangements to acquire the financing necessary to buy them. However, as we will discuss in Chapter 5, the decision to acquire an asset and the decision about how to finance it, although related, are separate and distinct decisions. For example, suppose that HOS plans on building a $100 million new wing that will generate $40 million a year in revenue. The revenue over the life of the wing may be sufficient to pay for its construction. However, the cash receipts from the wing in the first year will certainly not pay the full construction costs. That money may have to be borrowed. The revenue earned in the future has to be great enough to repay both the amount borrowed and the interest on that loan and a premium that justifies taking the risks related to making the investment. This requires careful calculations related to the timing of the cash receipts and payments related to the project, including all the costs of obtaining the money needed for the capital purchase. Capital budgeting, as noted previously, is discussed further in Chapter 5.

The Budget Process

Although a budget is a plan, budgeting is a process of planning and control. In the budget process, resources are allocated, efforts are made to keep as close to the plan as possible, and then the results are evaluated. "Properly applied, budgeting can contribute significantly to greater efficiency, effectiveness, and accountability in the overall management of an organization's financial resources."[3]

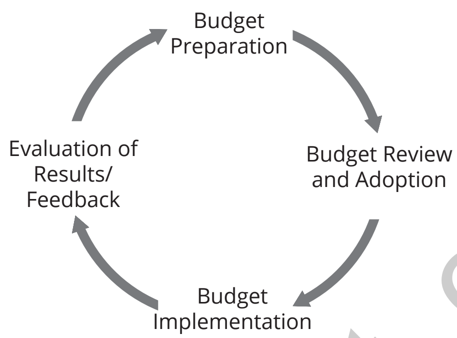
The budgeting process is one of exploring possibilities. Organizations determine what things they can do and what they cannot. They examine alternatives and choose those that will likely yield the best results. They become attuned to possible problems and can work to find solutions. Ideally, budgeting causes managers, policy makers, and legislators to think ahead, have clear expectations against which to measure performance, and coordinate the activities of the organization so that everyone is working toward a common purpose.

In larger organizations, coordination is inherently more difficult, and the budget process can become cumbersome. Such organizations will often have budget departments that devote substantial efforts to aid managers and policy makers in developing budgets. Governmental budgeting is often subject to a variety of laws, making the need for assistance even greater.

The budget preparation process includes developing revenue and spending projections. In modern government management, approaches for making projections vary from simple guesses to projections based on the current year plus inflation to use of sophisticated econometric forecasting. Forecasting is discussed further in Chapter 3.

The Budget Cycle

In most organizations, the budget process consists of a cycle of activities. We can summarize this cycle as follows:



The budget is first prepared. After review by the body with the authority to adopt the budget (often the board of trustees or the legislature), it is adopted with or without changes. It is not uncommon for the decision-making body to request or make changes prior to approval. Once approved, the budget is implemented. It is the responsibility of the management of the organization or the executive branch of the government to ensure that the adopted budget is carried out. Finally, the results must be evaluated. Often, actual results will vary from the adopted budget. This may be because of inefficiency, or it may be due to noncontrollable factors. All significant variations should be analyzed. This evaluation in turn will provide information to be used for feedback in preparing the next budget.

Budget Preparation. Initially, a draft budget must be prepared. Generally, top executives will prepare a set of assumptions and guidelines that department or agency managers should use as they develop detailed budgets for their areas. In government, the chief executive will generally provide a **budget guidance memorandum**, which provides policies, goals, and performance expectations.[4] The managers in the organization (unit and department heads or bureau chiefs and agency directors) then prepare draft budgets, considering their responsibility center's needs and the guidelines they have received. A responsibility center approach divides the budget into units for which individual managers are held accountable for their own operating results, called **responsibility centers**.

Organizations quantify their budgets, often assigning measures in dollars or units or both. For example, during the budget preparation process, Meals will need estimates of not only the dollar cost of meals but also the number of pounds of food needed and the number of meals they expect to serve. This requires plans to become specific so they can be summarized in a document that can be shared across the organization.

Budgets are prepared using forms that are generally unique to each organization. The forms help guide the manager to assess the need for resources to carry out the objectives of the responsibility center. The budget process will generally require the manager to justify the need for the requested resources. Chapter 3 provides additional discussion about the elements of a budget and some of the techniques that can be used in preparing budgets. Chapter 4 addresses issues related to planning for costs. Chapter 5 addresses special issues related to the capital budget.

It is common for budget requests to be "supported by detailed **objects of expenditure**—tabulations of the myriad items required to operate each program, including salaries and wages, rent, office supplies, travel, equipment and other inputs."[5]

Budget Review and Adoption. Budget requests are reviewed to ensure that the forms have been completed fully and without error. The budget requests from all responsibility units are aggregated to determine the total resources that have been requested. There is also a review to ensure that all the department budgets follow the same assumptions about salary increases, expected workload, and other factors that need to be consistent across departments.

It is common for the total of all spending requests to exceed projected revenues. In most cases, this requires the organization to go through a process of negotiation. The first goal of this process should be to eliminate any inefficiency in the budget. If this leaves the budget still unbalanced, it is necessary to find additional sources of revenue or to reduce spending. Spending reductions should be selected to minimize the impact on the accomplishment of the organization's goals and objectives. In many instances this requires the organization to establish priorities. Managers should be given the opportunity in this process to provide their rationale for why their budget requests are high priorities and should not be among the first items cut.

Once the top management of an organization is comfortable with the budget, it submits it to the decision-making body for review and approval. In the case of the government, the executive branch submits the budget to the legislative branch for review. In many cases, the legislative process includes an opportunity for public scrutiny and comment. In some cases, the public actually votes on the budget, but this is less common and occurs primarily with respect to school budgets. If the executive is unhappy with changes made by the legislature, the budget can be vetoed. In many cases the veto can be for the entire budget; in some cases, the veto may be line item by line item. Generally, there is some provision for the legislature to override a veto.

The body that must approve the budget should receive not only the budget but also an executive summary. This summary should focus on the policy implications of the proposed budget. One should try to avoid letting the trees get in the way of seeing the forest. Often the extreme detail provided with budgets causes managers to lose sight of the goals that should be accomplished as the budget is implemented.

Finally, after discussing and perhaps requiring changes in the budget, it is accepted by the board or, in the case of government, passed by a legislative vote in favor of an **appropriation**. When a legislative body—be it a senate, an assembly, a town committee, or a council—approves spending for a specific line item, it is called an appropriation. Appropriations create the authorization for spending the amount in the budget.

Budget Implementation. Once adopted, the budget must be implemented or executed. Steis described this part of the process:

> Budget execution is both a financial process and a substantive operational process. This stage of the budget cycle involves the initiation of authorized projects and programs within an established time schedule, within monetary limits, and ideally, within standard cost limits. Budget execution is the longest stage in the budget cycle, covering the full fiscal year and overlapping both the formulation and review stages of the budget for the succeeding and prior years, respectively.[6]

Budgets authorize and limit the amount of spending for each responsibility center in an organization. Appropriations tend to be specific in terms of the amount that can be spent and what it can be spent on. Governments next make **allocations**, subdividing the appropriation into more detailed categories, such as responsibility centers, programs, or objects of expenditure. Sometimes, spending is further broken down into **allotments**. Allotments refer to a system that allocates budget resources to specific periods or for use only after a certain event occurs. This allotment process serves "(1) to avoid premature exhaustion of appropriations, necessitating supplemental appropriations; (2) to keep the rate of expenditures in line with the flow of revenue; and (3) to provide the funds agencies actually need in the course of budget implementation and no more."[7] Although the process is not quite as formalized in other public service organizations, the same elements apply.

Part of the budget implementation process focuses on expenditure control. A widely used technique in governments and some not-for-profit organizations is a system of **encumbrances**. When the organization places an order for a resource, an encumbrance is created. The encumbrance identifies the portion of the budget for a specific line item that has already been spoken for by purchase commitments that have been made.

For example, suppose that the Millbridge Town Council has adopted a budget that includes an appropriation of $20,000 for computer equipment. On the first day of the government's fiscal year, October 1, an order is placed for $15,000 worth of equipment. The equipment arrives two months later. The government pays for the equipment a month after that. In the interim between the placing of the order and the payment for the computers, Dwight Ives, the town manager, would like to know how much money is available for computer purchases. He knows that the budget was $20,000, but he suspects that some purchases may have already been made. As soon as an order is placed, the government accounting system records an encumbrance in the dollar amount of the order. If Ives looks at the town budget report on November 1, he will see that the budget is $20,000, but that there is a $15,000 encumbrance. The available, or unencumbered, balance is $5,000. Special approvals are generally required to place additional orders that would exceed the unencumbered balance.

When the computers that were ordered have been received, the encumbrance will be removed. At that point the financial records would show a budget for computers of $20,000, an expenditure of $15,000, an encumbered balance of $0, and an unencumbered balance of $5,000.

Other aspects related to managing the organization within the limits of the adopted budget are discussed in Chapter 7, which looks at management of the short-term resources and obligations of the organization, and Chapter 8, which focuses on issues of accountability and control.

Evaluation of Results. The last element in the budget cycle is the evaluation of results. Budgets not only create plans but also can be used to help accomplish those plans. One way that this is done is by comparing actual results to the budget. This is sometimes referred to as performance evaluation. This is especially helpful if done on an interim basis during the year. That allows problems to be corrected midstream, helping the organization accomplish its budget.

Things do not always go as planned. It is important to attempt to assess why. In some cases, money is being wasted through inefficiency. If so, the inefficiency should be determined, and corrective action should be taken. In other cases, events have occurred (e.g., price increases in supplies that are essential) that are beyond the control of the organization or its managers. However, not all deviations from budgets are negative. Often, careful review can reveal opportunities an organization can use to its advantage. In any case, there should be a thorough investigation of why variations occur.

Looking at its results, the organization can assess what needs to be corrected and where it can take advantage of opportunities. How good a job did the organization's management do? How well did the organization itself do? Ideally, the organization's performance should be evaluated in a number of different ways. Meals wants to know if it served as many meals as expected and whether those meals cost more or less than expected. However, it also wants to know if the meals met its standards for nutrition. It wants to know if the homeless thought that the meals tasted good. The measurement of performance is discussed in Chapter 3.

To evaluate performance, one must have a standard or benchmark to use for comparison with actual results. The budget establishes the organization's expectations. When actual results vary from those expectations, the organization can use feedback to investigate the cause of the variations. The results of such investigation can provide the information needed to improve the management of the organization in the future. The difference between a budgeted amount and an actual result is called a variance. Variance analysis is discussed in detail in Chapter 8.

Governments often have a formal midyear review. This review serves a critical function. Because state and local governments must have a balanced budget, it is critical to examine whether the organization is on track for spending no more than the appropriated amount. If it turns out that spending is above the budget level, or that revenues are less than budgeted, then actions must be taken to avoid a deficit. Often this requires cutting expenditures for the remainder of the year to a lower level than had been expected when the budget was passed. Many health and not-for-profit organizations undertake similar reviews for the same purpose.

Another purpose of performance evaluation is to enhance accountability. All organizations want to ensure that their resources are used efficiently and effectively. The efficient and effective use of resources is enhanced if the organization can hold managers and responsibility centers accountable for their activities and results. Accountability is partly ensured by frequent comparison of the budget with actual results and analysis of the causes of variances. Another element critical to accountability is the audit process.

An **audit** is an examination of records or procedures. Operating audits (sometimes called "performance" or "efficiency and economy" audits) seek to identify inefficiencies in the way the organization operates so that they can be avoided in the future. Financial audits examine whether financial reports are presented in a fair manner and whether all resource use has complied with relevant laws, rules, or regulations.[8] Although not all audits are intended to dig deeply enough to discover all fraud and embezzlements, some audits are conducted specifically to determine if resources have been used for their intended purposes.

Mikesell used the example of a state's purchase of salt for its roads to distinguish between a financial audit and an operations (or efficiency and economy) audit:

> A financial audit would consider whether the agency had an appropriation for salt purchased, whether salt purchased was actually delivered, whether approved practices were followed in selecting a supplier, and whether agency reports showed the correct expenditure on salt. An efficiency and economy audit would consider whether the salt inventory is adequately protected from the environment, whether the inventory is adequate or excessive, and whether other methods other than spreading salt would be less costly to the community.[9]

Clearly, audits serve an important role in ensuring accountability in the use of resources.

Budget Presentation

Another element in accountability is the presentation of the budget. Organizations formalize their budgets by recording them in written form. This allows the budget to be used to communicate to all its managers. Human resource managers can do their job better by knowing the staffing plans of other departments. The managers of the recovery room in a hospital can manage their department better if those managers know the number of surgeries that are expected by the operating room department.

The choice of revenue and expense groupings and the level of detail of information shown in the budget can have a dramatic impact on the amount of information that is communicated by the budget. In the case of government, budgets become public documents. An effective presentation can give the public a tool to keep government accountable for its actions. The specific contents and presentation of budgets are discussed further in Chapter 3.

A Budget Timeline

The budget process can be quite complicated and time-consuming. The process may take one to three months in small organizations, and four to six months or even longer in larger ones. To ensure that the budget is ready for adoption sufficiently early to be implemented at the start of the coming year, many organizations prepare a budget calendar or budget timeline. Government timelines are often set by law or regulation. Examples of timelines are provided in Tables 2.10 and 2.11. These timelines indicate the deadline by which each major activity must be completed to ensure the possibility of timely adoption of the budget.

Note the word "possibility" in the previous sentence. Even if every deadline in the timeline is met, except for approval, the budget may not be adopted on time. The body that must approve the budget may decide that the budget is not acceptable. The process of revising the budget until it is acceptable may extend into the next fiscal year. In the case of not-for-profit organizations, the board generally will authorize that operations continue pending adoption of the budget but often at a reduced level of activity or on an austerity basis. This can be deleterious to the organization. At times, the final budget adopted calls for less spending than occurred during the period the organization operated without an approved budget. This results in even harsher cuts in spending for the remainder of the year. In rare cases, the organization will actually come to a halt with only the most essential activities continuing. This has happened to the U.S. federal government several times since 2013.

The budget timelines in Tables 2-10 and 2-11 both stop at the point of implementation. However, the process of auditing results, analyzing variances, and providing feedback for the next budget cycle is critical; this is shown in some organizations' timelines.

Table 2-10 ▪ Hospital Budget Timeline

Activity	Responsibility	Deadlines
1. Appointment of the budget committee	CEO	June
2. First meeting of budget committee	Committee chair	July
3. Complete assumptions and guidelines and communicate to department heads	Budget committee	August 31
4. Complete **long-range budget**	Budget committee	September 30
5. Unit capital and operating budgets	Unit managers	October 15
6. Negotiation between units and their department heads	Department heads	October 22
7. Compilation of all unit budgets into department budgets	Department heads	October 30
8. Development of cash budget	Chief financial officer	November 15
9. Negotiation and revision process	All managers	December 15
10. Approval	Board of trustees	December 16
11. Implementation	All managers	January

Table 2-11 ▪ Simplified Example of State Budget Timeline

(a) *Agency Budget Planning*		*April to Mid-September*
• Governor policy letter issued	Governor's office	April
• Bureau chiefs prepare budget requests	Bureau chiefs	April–June
• Agencies review bureau requests	Agency directors	July–August
• Agency budgets prepared	Agency directors	August–first half September
(b) *State Budget Review*		
• Agencies submit requests to Department of Budget (DoB)	Agency directors	One week after Labor Day
• Analysis by DoB	DoB	September–November
• Informal hearings	Budget examiners	September–November
• Formal hearings—comparative data	Budget director	September–November
• Final recommendations	Budget examiners	Mid-December
• Preparation of alternative plans	Fiscal analysts	Mid-December
(c) *Final Review*		
• Budget director recommendations on policy	Budget director	Mid-December to Mid-January
• Governor's decisions on policy	Governor	Mid-December to Mid-January
• Fiscal analyst plan recommendations	Fiscal analysts	Mid-December to Mid-January
• Governor and budget director formulate plan	Governor/budget director	Mid-December to Mid-January
• Budget message prepared	Governor	Mid-December to Mid-January
(d) *Passage of Budget Bill*		
• Governor submits budget bill to legislature	Governor	Mid-January to February 1
• Analysis, hearings, passage	Legislature	Mid-January to April
• Passage of special appropriation bills	Legislature	Mid-January to April
• Fiscal year begins—implementation of budget	Agency directors	April 1

Source: Adapted from New York State Division of the Budget, *Budget Request Manual* (Albany: New York State, 1983). This simplified timeline is not meant to indicate the current specific process of New York State.

Political Realities in the Budget Process

The process of developing budgets is highly politicized. This is true in most public service organizations. To the extent possible, managers should try to establish and use a transparent and objective budget process that best leads to the accomplishment of the organization's mission, goals, and objectives. In reality, it is inevitable that politics will play at least some role in almost all organizations.

Politics may take a variety of forms. The politics may be personal. A department manager may be a relative of a member of the board and may get, or be perceived as getting, special breaks at budget time. More broadly, however, politics often revolves around agendas. Proponents of a particular service or program will lobby for resources for that program. This is true in most organizations and may be especially pronounced in organizations with responsibility centers, where there often are perceptions that budgeting is a zero-sum game. That is, responsibility center managers may perceive intraorganizational competition for every dollar in the organization's budget.

Politics is of special concern in the government, which is, after all, a political arena. It is at least partly through the political process and voting that the public makes its desires known. Politics serves a major role in resource allocation in governments. Although budgets should be objective in trying to accomplish the goals and objectives of the organization, politics has an appropriate role in setting those goals and objectives.

Politics in the public sector takes many different shapes: It takes the form of special interest groups lobbying for their causes. It takes on the perspective of competing policies to accomplish similar or different objectives. Sometimes politics in budgeting is manifested as a power struggle between the branches of government or between political parties.

Managers should be aware of the political nature of budgets within their organization. This can help them better define their role in the budget process.

Behavioral Aspects of the Budget Process

Although it sometimes seems that budgets are all about numbers, this is not the case. Once a budget has been adopted, it is up to the employees of the organization to come as close as possible to achieving the budget. People are the key to successful budgeting. It is critical to understand that the actions of people within an organization have a tremendous impact on how well the organization does. If people work to accomplish the goals of the budget, we are likely to have much better outcomes than if they are indifferent about accomplishing those goals or, even worse, if they work in opposition to accomplishment of the organization's goals. The numbers on paper are just that. People—their attitudes, needs, and desires—are the key to budgeting. If we do not specifically focus on why people would want to accomplish the organization's goals as defined by the budget, we are not likely to achieve the best possible actual outcomes.

Therefore, an essential part of the budget process is understanding what motivates the organization's employees. We need to understand why employees would make their best effort to accomplish the organization's goals and why they would not. And we need to understand how incentives can be used to motivate employees to work at their highest level to accomplish the organization's goals.

The more input employees have in making plans, the more likely it is that they will strive to achieve them. People working in a unit or department of an organization know a great deal about how that unit or department functions. They are in a good position to propose changes that will improve efficiency. If we solicit input from managers and staff members in preparing budgets, and develop budgets based on that input, employees are likely to become vested in showing that the approaches they have proposed are sound. If budgets are prepared without staff input, staff will likely be much less motivated to meet the budgets that have been handed down to them.

Budgets and Motivation

Motivation is the critical underlying key to budget success. One of the best features of budgets is that they present a measurable goal. When there is a clearly stated goal, managers and staff can work toward that goal. Most people are inherently motivated to do a good job. They want to gain a sense of accomplishment from their job, and a budget goal can help them do that. Setting demanding but realistic budget goals, combined with public praise and rewards when goals are met or exceeded, can enhance motivation and resulting performance.

Compare the likely progress of a dieter with specific weight-loss goals to one who simply wants to lose a lot of weight, or compare an athlete who has measurable objectives to one who wants only to be strong or run fast. Setting specific goals and working toward them is a tremendous self-motivator. Most employees want to have a sense of pride in their organization and want their organization to do well. Nevertheless, a goal of spending as little as possible is no better than the dieter's hope to lose weight. A more specific goal, such as, "Let's reduce electric consumption by 10% as compared to the prior year" is likely to be a better motivator.

Control is complicated by the fact that even when the primary goal is clearly stated, it is the basic nature of individuals that their own personal goals will often be different from the goals of their employer. This does not mean that human nature is bad—only that there is such a thing as human nature and it is foolish to ignore it. For example, most employees would prefer a salary that is substantially larger than the salary they are currently receiving. There is nothing wrong with employees wanting more money. In fact, ambition is probably a desirable trait. In contrast, employers generally will not provide employees with more money because they lack the revenues to pay those higher wages. Although the employees are not wrong to desire large raises, the employer is not wrong to deny such raises. Inherently, a tension or conflict exists as a result.

Nor is it only an issue of salaries. Often employees would like larger offices with new furniture and remodeled facilities. They would certainly like more staff to enable them to carry out their department's mission more effectively. However, organizations have limited resources and must make choices concerning how to spend those limited resources.

As a result, even when morale is generally excellent and is not considered to be a problem, an underlying tension naturally exists. Even though the employees may want to achieve the mission of the organization, their personal desires will be for things the organization cannot or will choose not to provide. This is referred to as **goal divergence**. For example, employees might prefer to take long breaks frequently throughout the day. Doing so, however, might well impair their ability to efficiently get their work done.

To best achieve its goals, the organization must bring together the interests of the individual with its own interests so they can work together. In the budgeting process, the organization wants to control spending. But it is not the organization that controls costs: it is the human beings involved in the process. There must be some motivation for the human beings to want to control costs. We need to find a way for the employees to believe that it is in their interests not to take frequent, long breaks. Bringing the individuals' desires and the organization's needs together is referred to as **goal congruence**.

Because congruent goals are not inherently the norm, it is necessary to address formally how convergence is to be obtained. An organization generally achieves such convergence or congruence by setting up a system of incentives that makes it serve the best interests of the employees to serve the best interests of the organization.

Incentives

Although employees serving in government, health, and not-for-profit organizations are motivated by factors other than money, it would be foolish to ignore the potential of monetary rewards to influence behavior. Public service organizations must search for the proper mix of incentives that will motivate managers and staff to control costs. Financial incentives are frequently used. The most basic financial incentives are the ability to retain one's job and the ability to get a good raise. We can use a carrot or a stick to motivate. The stick might be: If you constantly take long breaks frequently throughout the year, you may be fired.

Another common motivating tool that incentivizes employees is a bonus system. This is a carrot approach. For example, one could tell a manager that their department budget for the year is $3 million. However, if the department spends less than $3 million, they and the staff can keep 20% of the savings. If the department spends only $2.9 million, the manager and the staff will get a bonus of $20,000 (i.e., $3 million less $2.9 million, multiplied by 20%) to share. The total cost to the organization is $2,920,000 including the bonus, as opposed to the $3 million budget, so it has saved $80,000 after paying the bonus. The staff benefits and the organization benefits. In this case, goal congruence is likely to be achieved. Workers will not take frequent, long breaks because they are trying to work more efficiently so they will earn the available bonus.

Many public service organizations have in fact added bonus systems. The use of bonus systems has both positive and negative aspects. The positives relate primarily to the strong motivation employees have to reduce costs. The negatives relate to the fact that bonuses sometimes create unintended incentives. For example, bonuses give employees a strong incentive to lower the quality of services provided to reduce costs and earn a bonus. Careful metrics must be put in place to ensure that the bonus is not being earned at the expense of the quality of products and services provided. Managers must try to anticipate unintended consequences when developing incentive systems. Also, the bonus must be adequately large to achieve the desired congruence. If you can get away with taking frequent long breaks, and you are inclined to do so, a bonus that adds up to only $10 a week for each employee might not provide sufficient motivation to change that behavior. Would $50 a week per employee be sufficient? $100? Each organization must give careful thought to developing a motivation system that provides sufficient incentives to achieve an appropriate level of goal congruence.

Another potential problem with bonuses relates to changes in volume of services provided. A bonus should not reward employees for lower spending that results simply from lower volume. Nor should employees fail to get a bonus simply because costs increased as a result of higher volume. We do not want to provide an incentive that results in employees being motivated to reduce the volume of service provided. Making the bonus system adjust automatically for changes in volume can avoid creating an incentive to reduce the volume of services provided.

Bonuses are not the solution to all motivational problems. Bonus systems have a variety of other problems. Some bonus systems reward all employees equally if overall spending is reduced. But if everyone gets a bonus, no one feels that their individual actions have much impact. Individuals may believe that they do not have to work particularly hard to reap the benefits of the bonus. They will let everyone else do the hard work, and they will share in the bonus distributed. That can lead to a situation in which no one makes any effort to control costs. There will not be a bonus to be shared, and the organization will not keep costs under control. In that case, the bonus system will not be providing the incentives we need. In contrast, bonuses given to only some employees based on their individual performance may create jealousy and discontent.

There are incentive alternatives to bonuses. For example, one underused managerial tool is a letter from supervisor to subordinate. All individuals responsible for controlling costs should be evaluated explicitly with respect to how well they control costs. That evaluation should be communicated in writing. This approach costs little to implement but can have a dramatic impact. Most people respond well to praise and other forms of positive feedback about their personal performance and their department's performance. Framed certificates of achievement along with a moderate monetary reward for an outstanding achievement can be a strong motivator. Employee of the month and other similar programs can be strong motivational tools as well.

Telling individuals they have done a good job and that their boss and their boss's boss know that they have done a good job can be an effective way to get people to continue trying to do a good job in the future. We tend to take a biased approach, complaining to employees when there is a problem without correspondingly praising them for a job well done when there are no problems. In the real world praise is both cheap and, in many cases, effective. In contrast, fair criticism, especially in writing, can have a stinging effect that managers and staff will work hard to avoid in the future. Ultimately, however, people tend to respond better to praise than to criticism.

Unrealistic Expectations

There is no question that many people do attempt to satisfice—to do just enough to get by. One thing incentives are used to accomplish is to motivate those individuals to work harder. A target that requires hard work and stretching, but that is achievable, can be a useful motivating tool. If the target is reached, there might be a bonus, or there should be at least some formal recognition of the achievement, such as a letter. At a minimum, the worker will have the self-satisfaction of having worked hard and reached the target.

However, it is important to recognize that budget targets should be achievable. Some organizations have adopted the philosophy that if a high target makes people work hard, a higher target will make them work harder. This may not be the case. If targets are placed out of reach, they will probably not result in people reaching to their utmost limits to come as close to the target as possible. In fact, that approach may lead to cynicism and hostility toward a management that promises to make bonuses available and then places them out of reach. It may seem that the organization is short-changing itself whenever someone achieves a target. One may think, "We set the target too low. Perhaps if the target were higher, the higher target would have been achieved." The problem with that logic is that there are risks associated with it. If an employee fails to meet a target because of incompetence or because of insufficient hard work, the signal of failure that is sent is warranted. In fact, repeated failure may be grounds for replacing that individual in that job. But if an employee is both competent and hardworking, failure is not a message that should be sent. Even if it is desirable to encourage the individual to achieve even more, the signal of failure will be discouraging.

When people work extremely hard and fail, they often question why they bothered to work so hard. If hard work results in failure to achieve the target, then why not ease off? If they are going to fail anyway, why try hard? And when people get discouraged, they may become angry. This situation can lead to turnover and even sabotage by angry persons who believe their supervisors are against them and that they are being set up to fail. Thus managers at every level of the organization must be extremely careful to ensure that all goals assigned are reasonable, or results may be less favorable than they otherwise would be.

Case Study
Developing a Government Budget

To gain a better sense of the budget development process, we will now discuss the development of a hypothetical budget for Millbridge. According to Ives, Razek, and Hosch, these are some of the specific steps that must be taken:

- Prepare budgetary policy guidelines.
- Prepare a budget calendar.

- Prepare and distribute budget instructions.
- Prepare revenue estimates.
- Prepare departmental (or program) expenditure requests.
- Consolidate departmental expenditure requests and revenue estimates.
- Prepare the budget document.
- Present the budget document to the legislative body.
- Determine the property tax (millage) rate.[10]

We will consider each of these steps in turn.

Prepare Budgetary Policy Guidelines

As noted, the first step in budget preparation is for the top management to prepare a budget guidance memorandum that provides assumptions and guidelines about policies, goals, and performance expectations that managers should use as they develop detailed budgets for their areas. The Millbridge guidelines indicate that, given current economic conditions, an average increase in all taxes and fees of 3% would be considered acceptable. Due to a housing boom in the town, population growth of 5% is expected, and this will translate into increased property values and sales tax. Inflation in the cost of supplies is expected to be 4%; if possible, employees will be given 5% salary increases.

Prepare a Budget Calendar

The budget process can take three to six months, or even longer. To ensure that everything is done efficiently, Millbridge prepares a budget calendar (see Table 2-12).

Prepare and Distribute Budget Instructions

As we can see from Table 2-12, the budget committee meets to set guidelines from July 1 to 5. These guidelines are distributed to department heads on July 10, along with specific instructions for completing the budget. The materials provided should give each department head information about their current year budget, their actual expenditures to date, and projected expenditures through the end of the year. Additionally, it should provide guidance regarding anything that would affect the departments, but of which the department heads might be unaware. For example, the school superintendent should be informed if new housing construction will likely affect the number of students in the school system. The same housing construction and resulting expansion of the town population might also affect the service demands on police, fire, ambulance, and public works. Each department must be informed for its budgets to reflect the resources needed to maintain the desired level of services.

Prepare Revenue Estimates

The money available to the town for the coming year will consist of its revenues generated for the year as well as any surplus carried over from the previous year.

Table 2-12 ▪ Millbridge Budget Calendar

July 1–5	Mayor, town manager, and other key officials meet to develop budget guidelines.
July 10	Department heads receive budget guidelines and forms.
August 31	Department budget requests must be submitted to town manager.
September 10–15	Meetings are held among the mayor, town manager, and department heads to discuss individual department budget requests.
September 16–30	Department heads revise and resubmit budget requests.
October 15	Town budget is presented to town council.
October 15–31	Town council holds meetings to discuss budget.
October 31	Town council proposes adjustments to the budget.
November 1–15	Budget is revised and printed.
November 15	Budget is mailed to residents.
December 1–15	Public hearings on the budget are held.
December 16	Town council votes on budget.
January 1	New budget year begins.

Therefore, the finance department of the town, working with each department manager, should estimate any surpluses that will likely exist at the end of the current year. In Table 2-13 we can see that total projected 2026 revenues of $14,757,133 are about $53,000 above budgeted revenues of $14,704,150. However, any changes in expenses from the budget would also have to be considered before knowing if Millbridge expects to have a surplus at the end of the current year.

The next step is to determine revenues for the coming year. For each department we first attempt to determine what current year results will be. Typically, a budget worksheet would provide the information shown in Table 2-13. The first numerical column in this table shows the actual results for the entire year prior to the current year. Next, the budget for the current FY 2026 is shown. From the first two columns we can see the expected changes from last year to the current year. That information may be helpful in planning the changes from the current year to the coming year. Next, we see the actual revenues for the current year to date. Assume that Millbridge's fiscal year is identical to the calendar year. Because this information is provided to Millbridge department managers in July, only six months' worth of actual data are provided. A projection must then be shown for the remaining months of the current year as well as for the entire current year.

This projection requires care. One cannot assume that the second half of the year will be like the first half. In Table 2-14 we see that property tax revenues for general government and education revenues are expected to split evenly between the two halves of the year. By contrast, sales tax revenues are not. The total projected sales tax for 2026 is above the budget for the year, possibly indicating that by the time the 2027 budget was being prepared, the expectations were that the 2026 holiday sales season was going to be stronger than had been anticipated a year earlier.

Table 2-13 ▪ Millbridge Revenue Budget FY 2027

Department	2025 Actual	2026 Budget	Jan–June 2026 Actual	July–Dec. 2026 Projected	Total 2026 Projected	2027 Budget
General Government						
Property Tax	$6,344,928	$6,747,196	$3,373,598	$3,373,598	$6,747,196	$7,297,093
Sales Tax	253,797	269,888	127,387	173,920	301,307	325,864
Education	4,856,028	5,163,900	2,581,950	2,581,950	5,163,900	5,318,817
Public Safety	1,198,855	1,274,862	601,735	702,351	1,304,086	1,343,209
Public Works	0	0	0	0	0	0
Health and Sanitation	355,920	378,485	178,645	193,028	371,673	382,823
Recreation	529,541	405,344	148,523	264,333	412,856	589,834
Water	294,305	312,964	147,719	159,612	307,331	316,551
Sewer	142,478	151,511	71,513	77,271	148,784	153,247
Total	$13,975,852	$14,704,150	$7,231,070	$7,526,063	$14,757,133	$15,727,438

Note: Line items may not precisely sum due to rounding.

The managers should use forecasting approaches (see Chapter 3 for a discussion of forecasting) to estimate their likely revenues for the coming year. The budget guidelines for Millbridge have also provided the town's managers with some information. Specifically, tax rates are expected to increase by 3%, and population is expected to grow by 5%. That population growth is expected to affect both property and sales taxes. Managers considered those factors when preparing the 2027 budget (Table 2-14).

Additionally, individual managers may be aware of specific reasons why their revenues might differ for the coming year. For example, suppose that the town's pool was closed during the current year for major renovations. This would adversely affect the revenues of the recreation department. Notice that the 2026 budget for recreation revenues was down from the 2025 actual result in anticipation of the renovations. Next year the pool will be open, and with the improvements it will likely attract more members than ever before. The head of Millbridge Recreation Department has taken that revenue growth into account in preparing the budget for the coming year.

Some departments may not have any direct revenue. For example, the Public Works Department may be funded by the general revenues of the town. In such instances, its budget will not include a revenue component.

In Table 2-13 the revenue increases that are projected are largely the result of an increasing tax base due to construction and an assumption that all tax rates will be increased by 3%. At this point the budget has not been approved, and tax rate increases that are ultimately approved may be greater or smaller than that amount, requiring adjustments to the revenue budget. According to the timetable in Table 2-13, the revenue budgets would have to be submitted by August 31.

Table 2-14 ▪ Millbridge Recreation Department Expenditure Budget, Personnel Services FY 2027

		2025 Actual			2026 Estimated			2027 Budget		
Position Code	Position Title	Hours	Rate	Amount	Hours	Rate	Amount	Hours	Rate	Amount
1001	Director	2,080	$40.10	$83,408.00	2,080	$41.30	$85,904.00	2,080	$43.37	$90,209.60
1002	Pool Manager	693	20.50	14,206.50	693	21.12	14,636.16	693	22.17	15,363.81
1003	Golf Course Manager	693	18.40	12,751.20	693	18.95	13,132.35	693	19.90	13,790.70
1004	Tennis Club Manager	693	18.40	12,751.20	693	18.95	13,132.35	693	19.90	13,790.70
1010	Lifeguards	6,240	12.00	74,880.00	4,160	12.36	51,417.60	6,411	12.98	83,214.78
1020	Maintenance Workers	10,400	10.25	106,600.00	9,360	10.56	98,841.60	10,574	11.09	117,265.66
1030	Clerical	4,160	14.75	61,360.00	4,160	15.19	63,190.40	4,160	15.95	66,352.00
		24,959		$365,956.90	21,839		$340,254.46	25,304		$399,987.25

Note: Line items may not precisely sum due to rounding.

Prepare Departmental (or Program) Expenditure Requests

Each department must prepare a detailed listing of the items that it believes it needs to fund for the coming year. Often the requests of all departments, when combined, will exceed revenues. At that point either revenues will have to be raised (by actions such as tax increases) or negotiations will take place with departments to reduce their expenditure levels.

Ives, Razek, and Hosch suggested seven steps to prepare an expenditure budget. First, one should ascertain the expenditures for the last year and project what they will be for the coming year. Second, to arrive at a stand-still level of spending, it is necessary to incorporate inflation and cost of living and to allow for uncontrollable factors. Third, changes have to be accounted for by determining which new activities, if any, will be undertaken, as well as expansion, contraction, or discontinuance of any current activities. Fourth, the amount to be spent must be adjusted for the changes identified in step 3. Fifth, justifications must be prepared for all changes identified in step 3. These justifications should account for the impact of both undertaking each change and not undertaking each change. The sixth step is to develop a worksheet for each type of expenditures. These worksheets will need to be tailored for each type of expenditure but in all cases should include information in detail for the previous year, current year, and projected year being budgeted. Finally, the individual worksheets should be summarized.[11]

Generally, departmental expenditure budgets are divided into budgets for personnel, known as personal or personnel services (PS), other than personnel services (OTPS), and capital budgets. Based on the timetable in Table 2-13, all the expenditure budget requests would have to be submitted by August 31.

Personnel Services

The personnel budget lists all the categories of employees, the number of paid hours expected for the category, the pay rate, and the total pay. Frequently, the document will include not only the budget request for the coming year but also the actual value for the prior year and the projected spending for the current year. See Table 2-14 for an example of the Millbridge Recreation Department personnel budget for the 2027 year. A similar budget would be required for each department. Millbridge assumes that a full-time worker will be paid for forty hours a week for fifty-two weeks a year. Therefore, the director of the Recreation Department, who is a full-time year-round employee, will be paid for 2,080 hours. The three manager positions cover only the four summer months, so they are budgeted for 693 paid hours each year. The lifeguard and maintenance hours dropped during 2026, when the town pool was being renovated. Both figures are expected to increase in 2027 once the renovation is complete.

The budget for 2027 includes raises of 5%, in accordance with the budget guidelines provided to each manager, but does not include fringe benefit costs, which would often be added directly by the government's finance department when the individual department budgets are combined to get the overall costs of the governmental body. Fringe benefits are usually calculated as a percentage of wages. Fringes include payments into the Social Security system (Federal Insurance Contributions Act or FICA), health-care benefits, retirement plan payments, and a variety of other costs. The fringes are not determined employee by employee. Rather, an average rate is used for a large segment of employees. A typical rate might be around 30% of wages in a not-for-profit or health organization and in excess of 50% in government. Fringes can have a dramatic impact on any organization's spending. For example, one of the largest components of the overall fringe rate is the cost of employee health insurance. If health insurance costs increase more than expected, the fringe benefit rate can easily increase at least several percent, creating a large budget imbalance for the organization.

Many government bodies adopt personnel classification systems that list the types of positions that exist and establish a pay grade for each. Individual pay grades often have steps, allowing employees to move up in pay over time, even if they are not promoted to a new position. In a given year an employee may move up a step to reflect experience and longevity and also receive a general salary increase that is applied across the board to all grades and steps. Once individuals have reached the top step for their grade, they must change to a different position at a higher grade or else receive only general salary increases each year.

Some of the benefits of a classification system are a greater degree of uniformity in pay for positions requiring similar skills. They also allow for systematic and consistent consideration of employee experience and longevity. Also, if budgeted positions are vacant when the budget is prepared, or new positions are being added in the coming year's budget, the budget can still be prepared with some degree of certainty about expenditures because the classification system dictates the wages that will be earned when the positions are filled. Some critics are concerned, however, that when the public is told that raises are going to be 5% for government employees for the coming year, they may not be aware that many employees receive substantially bigger raises than 5% when their step increases are considered.

Other Than Personnel Services

The other major part of the operating budget for departments is referred to as the personnel (OTPS) budget. This would include a variety of different types of expenses such as office supplies, subscriptions, and copying costs. Again, the actual budget form would typically include information about the prior and current years as well as the projected budget request for the coming year. In making their budget projections for the coming year, managers must carefully determine what most influences the amount that must be spent on each item. For example, office supply costs might vary based solely on inflation. However, the amount spent on the supply items to test the composition and safety of the pool water might vary most with the number of hours the pool will be open (assuming that the water is tested once an hour during all hours of operation). If the renovated pool will be open more hours, then we must anticipate the cost of additional supplies to test the water.

Some organizations budget for OTPS costs using a formula to simplify budget calculations. For example, a government may have found that historically, the amount spent on supplies can be related to the number of workers. To budget supply costs for the future, one would first determine the increase or decrease in the number of workers. Then one could estimate the change in supply cost due to inflation. Suppose that an agency spent $80,000 on supplies last year and expects a 2% increase in manpower and a 3% increase in the price of supplies. The budget for the coming year would increase to $81,600 to cover the manpower increase ($80,000 + [2% × $80,000] = $81,600) and then to $84,048 to cover the price increase ($81,600 + [3% × $81,600] = $84,048). This is a much easier approach than trying to figure out exactly how many pens, pads, and paper clips will be needed.

Similar rules of thumb can be used in budgeting for other OTPS costs. For example, when planning on the purchase of blacktop for pothole repair, the Department of Transportation might develop a formula based on tons of blacktop needed in a typical year per mile of two-lane road that must be maintained. That could be adjusted for roads that have more than two lanes.

Capital Budgets

Earlier in the chapter we discussed capital budgets and explained that a separate capital budget is generally prepared. We will assume that Millbridge is not planning any capital expenditures for the coming year. Capital budget issues are discussed further in Chapter 5.

Consolidate Departmental Expenditure Requests and Revenue Estimates

Once the revenue estimates and expenditure requests have been prepared, all the elements from all the departments can be consolidated so that the initial projected surplus or deficit can be calculated. Based on the timetable presented in Table 2-12, this consolidation would take place during the first ten days of September. We can see in Table 2-15 that the general revenues of Millbridge are expected to be substantially more than the amount needed to cover general administrative costs. Also, the school system is budgeted to only cover its costs. However, a number of departments are projecting deficits. Public Works, which has no revenues of its own, is projecting the largest deficit amount. Public Safety is another department that requires large amounts of support from the general revenues of the town. In contrast, the Recreation, Water, and Sewer Departments have all submitted budget requests that project surpluses.

The mayor, town manager, and other key top-level executives of Millbridge would review the consolidated budget from September 10 to September 15. Overall, the consolidated budget requests result in a projected deficit of greater than $1 million. If the town has a requirement to show a break-even or surplus budget, then the draft budget in Table 2-16 will be unacceptable. It will be necessary to either increase tax rates further, find other revenues, or trim expenditures. According to the budget timetable in Table 2-13, department heads will revise budgets during the last half of September so that the finalized budget can be submitted to the town council on October 15.

Prepare the Budget Document

Once the budget has been changed (which may take a number of rounds), and the chief executive officer (in the case of Millbridge, the mayor and the town manager) has decided

Table 2-15 ▪ Town of Millbridge Draft FY 2027 Budget

	Projected Revenues	Projected Expenditures	Projected Net
General Revenues			
Property Taxes	$ 7,297,093		
Sales Tax	325,864		$ 7,622,957
General Administration			
PS		$ 3,104,095	
OTPS		1,076,523	(4,180,618)
Education			
School Taxes	5,318,817		
PS		4,295,403	
OTPS		1,023,414	0
Public Safety			
Fines and License Revenue	1,343,209		
PS		2,357,349	
OTPS		423,520	(1,437,660)
Public Works			
Revenue	0		
PS		2,139,542	
OTPS		924,008	(3,063,550)
Health and Sanitation			
Fee Revenue	382,823		
PS		295,468	
OTPS		98,463	(11,108)
Recreation			
Fee Revenue	589,834		
PS		399,987	
OTPS		180,549	9,298
Water			
Usage Charges	316,551		
PS		228,435	
OTPS		73,058	15,058
Sewer			
Usage Charges	153,247		
PS		84,375	
OTPS		42,058	26,814
Total			(1,018,809)

Note: Line items may not precisely sum due to rounding.

Table 2-16 ▪ Town of Millbridge Approved FY 2027 Budget

	Projected Revenues	Projected Expenditures	Projected Net
General Revenues			
Property Taxes	$7,671,435		
Sales Tax	325,864		$7,997,299
General Administration			
PS		$3,001,435	
OTPS		983,564	(3,984,999)
Education			
School Taxes	5,318,817		
PS		4,295,403	
OTPS		1,023,414	0
Public Safety			
Fines and License Revenue	1,343,209		
PS		2,139,743	
OTPS		388,426	(1,184,960)
Public Works			
Revenue	0		
PS		1,983,045	
OTPS		884,356	(2,867,401)
Health and Sanitation			
Fee Revenue	382,823		
PS		295,468	
OTPS		98,463	(11,108)
Recreation			
Fee Revenue	589,834		
PS		399,987	
OTPS		180,549	9,298
Water			
Usage Charges	316,551		
PS		228,435	
OTPS		73,058	15,058
Sewer			
Usage Charges	153,247		
PS		84,375	
OTPS		42,058	26,814
Total			0

Note: Line items may not precisely sum due to rounding.

that the budget is acceptable, a formal budget document is prepared. This document will include a message to the reader addressing the financial situation of the government and discussing what the budget tries to accomplish. New programs will be discussed, as will significant changes in revenues or expenditures. The budgeted revenues and expenditures are shown along with detailed supporting schedules allowing the reader to better understand what the summary numbers represent. Justifications will typically also be provided so that the reader understands the negative consequences of eliminating any of the elements of the budget. This does not mean that the budget must be adopted as submitted but rather that the reader should understand the implications of various types of changes.

Present the Budget Document to the Legislative Body

Once prepared, the budget document is sent to the legislative body for review and adoption. In the case of Millbridge, the budget is presented to the town council on October 15. For the next two weeks, the council holds meetings to discuss the budget. The council members may accept the budget as proposed, or they may adjust it. If the budget is adjusted, it must be made available to the public before legislative approval. This is followed by public hearings on the budget before the final vote by the town council. Public hearings are common practice by governments although not universal. The timing of the public hearings will vary as well. They may come at an earlier point than they do in this example. The budget is adopted by passage of an appropriation ordinance or act, which establishes the maximum spending by the government body for the coming year. The approved Millbridge budget, as revised by department managers and by the town council, appears in Table 2-16

Determine the Property Tax (Millage) Rate

Once the budget has been passed, the legislative body must enact legislation to provide revenues in support of the budget. Some revenues are recurring and do not require any annual action on the part of the government. For example, Millbridge might have a sales tax that continues at a set rate unless specifically changed by the government. Similarly, rates are established for parking tickets, licenses, and other sources of revenue. However, for many local governments one of the primary sources of revenue, the property tax, is adjusted each year.

This approach is not universal. In some localities, the property tax is a flat percentage of assessed property value, and that percentage does not change from year to year. As assessed values change, the revenues from the tax will change correspondingly. That does not require any action on the part of the legislature each year. However, it also substantially limits the ability of the local government to control its revenues. As a result, expenditures must be matched to available revenues. In localities where the property tax rate is adjusted each year, the government has a greater ability to adjust revenues to meet expenditure needs.

Millbridge is assumed to have a property tax rate that is adjusted annually. Usually such rates go up from year to year, but that is not necessarily the case. For example, in an older community with a falling number of school-age children, the costs of the educational system may drop enough to actually allow property tax rates to decline. Also, if property values are rising rapidly, then the assessed property tax base may rise enough to offset the need for a tax increase. In the case of Millbridge, additional housing construction is increasing the tax base. Also, with the opening of a new direct rail connection to the nearby large city, house prices in the town have risen dramatically.

The overall increase in the assessed value therefore offsets some of the additional costs of services that will be incurred due to the larger town population.

From Table 2-17 we see that the property taxes for general revenues will be $7,671,435, and school taxes will be $5,318,817 for Millbridge for the coming year. In the case of Millbridge, both of these property taxes are collected by the town, but the tax rates are stated separately. Due to exemptions from tax for not-for-profit organizations, veterans, and the elderly, not all property in Millbridge is taxed. Also, based on past experience, Millbridge has found that a portion of billed taxes is never collected from property owners. They have found that adding 1% to the amount needed for the budget provides an appropriate cushion to cover those uncollectible amounts. Table 2-17 shows how Millbridge would take the following approach to set its tax rates:

Table 2-17

Total Assessed Value of Property in Township		$1,423,540,000	
Property Exempt from Tax		(180,243,000)	
Net Assessed Value of Property		$1,243,297,000	
Amount Needed for General Revenues (see Table 2-16)		$7,671,435	
Allowance for Uncollectible Taxes (1%)		76,714	
Required Levy for General Revenues		$7,748,149	
Amount Needed for Schools		$5,318,817	
Allowance for Uncollectible Taxes (1%)		53,188	
Required Levy for Schools		$5,372,005	
Calculation of Tax Rate:			
Tax or Millage Rate	=	$\frac{\text{Required Tax Levy}}{\text{Net Assessed Property Value}}$	
Town General Revenues Property Tax	=	$\frac{\$7{,}748{,}149}{\$1{,}243{,}297{,}000}$	= 0.00623
School Property Tax	=	$\frac{\$5{,}372{,}005}{\$1{,}243{,}297{,}000}$	= 0.00432
Combined Property Tax Rate	=	0.00623 + 0.00432	= 0.01055

For a homeowner with a house appraised at \$300,000, the taxes would be calculated by multiplying the rate by the appraised value:

\$300,000 × 0.00623 = \$1,869.00 Town Tax

\$300,000 × 0.00432 = \$1,296.00 School Tax

\$300,000 × 0.01055 = \$3,165.00 Total Property Tax

These rates would normally be multiplied by \$1,000 to get the tax rate per \$1,000 of assessed value. For example, the overall property tax rate would be \$10.55 per \$1,000 of assessed value (0.01055 × \$1,000). The rates per thousand dollars of assessed valuation are called **mill rates**. New tax bills should be mailed out as early as possible to ensure that the government collects its property taxes on time.

In this example, Millbridge found it sufficient to add 1% to the total tax bill to account for uncollectible taxes. Estimates of uncollectible taxes are often based on historical experience and estimated as a percentage of the tax bills sent to residents. Were that the case, Millbridge would calculate the amount of the required levy by dividing the total amount by one minus the uncollectible tax rate to calculate the required tax levy. In this example, \$7,671,435 needed for general revenues would be divided by 1 – 0.01 = 0.99, resulting in a general revenue tax levy of \$7,748,924. That would add \$775 to the required general revenue tax levy, a small difference but one that would grow with both the size of the budget and the proportion of the tax levy that went uncollected.

Summary

Having a plan is essential for getting the most out of any organization. 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 objectives, and preparing specific, detailed budgets that define the resources needed to accomplish its goals and objectives.

A budget is simply a plan. The plan shows how management expects to obtain and use resources to achieve the organization's objectives. It provides a detailed action plan. There is no magic to budgeting. It requires thought. Budgeting requires estimating all the likely receipts and all the likely payments. The process usually requires a number of preliminary drafts and revisions before a feasible plan is developed and accepted by all parties. Once approved, efforts must be made to try to keep as close to the plan as possible.

Although some budgeting is done on an ad hoc basis (special purpose budgets), most budgeting is done at regular intervals. The master budget incorporates and summarizes all the budget elements for the coming year. The main elements of the master budget, sometimes called the comprehensive budget, are the operating budget and the financial budget. The operating budget presents a plan for revenues and expenses for the fiscal year. The financial budget includes a cash budget and a capital budget. Whereas the cash budget focuses on cash flows for the fiscal year, the capital budget considers outlays for resources that will provide service for a number of years into the future.

Some organizations acknowledge, or recognize, support and revenues only when they are received in cash. In those cases, expenses are recognized only when they have been paid in cash. They are said to use a cash basis of accounting. By contrast, if revenue is recognized in the year service is provided, the organization is said to be using an accrual basis of accounting. Accrual accounting is more difficult than cash accounting, but it provides a matching of revenues and expenses, allowing the manager to get a better sense of the profitability of the organization's activities.

The process of developing budgets is highly politicized. To the extent possible, managers should try to use an objective budget process that best leads to the accomplishment of the organization's mission, goals, and objectives. All organizations seek to accomplish some end. Hospitals exist to provide health-care services to their communities. Museums exist to provide the public with access to fine art. Governments exist to provide essential services. The budget becomes the tool to facilitate the accomplishment of these missions.

Key Terms from This Chapter

accrual basis
allocations
allotments
appropriation
audit
budget
budget guidance memorandum
capital assets
capital budget
cash basis
cash budget
depreciation expense
domain
encumbrances
expenditures
expenses
financial budget
fiscal year
goal congruence
goal divergence
line item
long-range budget
long-range plan
master budget
matching
mill rates
mission
mission statement
modified cash basis
objects of expenditure
operating budget
outcomes
output
profit
recognition
responsibility centers
revenues
special purpose budget
strategic plan
strategy
support
uncollectibles

Questions For Discussion

2-1. How does planning help an organization?

2-2. What is the organization's mission, and why is it important?

2-3. What is the purpose of the strategic plan?

2-4. What is the role of the long-range plan?

2-5. Why are budgets used?

2-6. Why would a special purpose budget be used?

2-7. What are the different types of budgets?

2-8. Why might a responsibility center organizational design exacerbate organizational politics?

2-9. How are budgets useful for motivation?

2-10. How do individual goals differ from organizational goals?

2-11. No matter how carefully we budget, things sometimes differ from our plan. If you were the manager of an organization in 2020, how do you think the COVID-19 pandemic might have affected your organization's actual results as compared to the budget?

2-12. See the previous question. Assuming your organization was significantly affected by the COVID-19 pandemic, what actions would you have taken moving forward?

2-13. Discuss the concept of goal congruence.

2-14. What are several incentive approaches? Are there weaknesses in any of the approaches?

2-15. What are some negative consequences of unrealistic budget expectations?

2-16. What are the elements of the budget cycle?

2-17. How does the basis of accounting affect what is in a budget?

2-18. What is a modified cash basis of accounting?

2-19. What is the purpose of a budget timeline?

Problems

2-20. Finn Fixes is a new charity that repairs donated cars for use by unemployed job seekers. Finn collects the cars from area junkyards. The first year Finn is in operation, jobs programs bought cars from the organization for $60,000. They paid Finn $45,000 during the year and owe $15,000. Finn uses donated, unskilled labor and free garage space at a local high school. Its only cost is for parts. Total parts cost $58,000 for the year. During that first year Finn paid its parts suppliers $52,000. It owes its suppliers the balance.

1. What is the profit or loss to Finn Fixes on a cash basis?
2. What is the profit or loss to Finn Fixes on an accrual basis?
3. If Finn Fixes were to stop operating at the end of the first year but received payment from the jobs programs and paid its suppliers, what would its cash budget for the next year be?
4. How much cash would Finn Fixes have on hand at the end of the second year? How does that amount compare to its budgeted accrual basis profit or loss for the first year?
5. Which basis reflects the long-term stability of the organization?

2-21. Accrual budgets plan for expenses for supplies when ____, whereas cash budgets plan for the expense when ____. (Choose from the following.)

1. they are ordered
2. they will be delivered to the organization
3. they will be paid for
4. they will be consumed
5. it depends of the type of expense

2-22. Although the COVID-19 pandemic was devastating to millions of people and organizations, not everyone suffered equally. While small businesses without backup resources were closing, and millions waited on food lines to get supplies needed to literally survive, organizations with significant endowments, such as universities and museums, were better able to weather the storm. Assume your organization had $100 million invested in an S&P 500 Stock Index fund on February 1, 2020, as the pandemic was starting. How much was that endowment worth on August 31, 2021, a little more than a year and a half into the pandemic? Does this give you a new perspective on the importance of fundraising and developing an organizational endowment? (Hint: You need to do an internet search to find the data you need.)

2-23. Answer the following questions about methods of accounting.

1. On the accrual basis of accounting, revenues and support are recognized when an organization ____ an amount that it is likely to collect, and it recognizes expenses when it ____ a resource.
2. Accrual-based expenses associated with capital assets are called ____.
3. Capital projects are evaluated on the ____ basis of accounting.
4. Loan repayments are resource outflows on the ____ basis of accounting but not on the ____ basis of accounting.
5. Borrowed amounts are resource inflows on the ____ basis of accounting but not on the ____ basis of accounting.

2-24. Monroe Outpatient Surgery Center (MOSC) is developing an operating budget for the month ending June 30, 2027. MOSC expects to perform eighty surgical procedures during the month. MOSC's average charge (price) per surgical procedure is $2,500. The cost of disposable surgical supplies is $300 per surgical procedure. MOSC also contracts with orthopedic surgeons at a fee of $1,500 per surgical procedure. The monthly salaries for MOSC's receptionist, bookkeeper, and two surgical nurses total $10,500. MOSC's occupancy costs, which include space rental, insurance, and all utilities, are $8,200 per month. Average monthly communication costs are $1,200. Office and operating room equipment was installed at a cost of $240,000. The equipment is expected to have a five-year life and has no salvage value. Prepare MOSC's operating budget for the month of June 2027.

2-25. Westchester City is constructing a new city hall. The building will cost $40 million and is estimated to have a useful life of forty years. Based on the experience of similar cities and the best estimates of the city's engineers, Westchester's planners expect that at the end of forty years the building will have to be torn down and rebuilt, so it is not expected to have any value at the end of forty years. It will cost $6 million to acquire equipment for the new center. Equipment is assumed to last for ten years. The city estimates that the equipment can be sold for 20% of its cost at the end of its useful life. If the city undertakes this project, what will the building and equipment expense be in the first year after the center is opened? (Hint: Depreciation expense is discussed in Chapter 10.)

2-26. Children's Best Hope (CBH) provides day-care services to low-income families. CBH bills the state for its services under a service contract. Billings for the first four months of 2026 are anticipated to be as follows:

January	February	March	April
$220,000	$200,000	$240,000	$230,000

CBH finds that it collects 25% of the amounts billed in the month of service with the balance collected in the month following service.

CBH is planning to acquire a new building as an additional site for its services in March 2026. The full $250,000 purchase cost of the building will be financed with a mortgage loan. CBH anticipates a February 28, 2026, cash balance of $26,000. CBH anticipates the following expenses and disbursements for the month of March 2026:

Payroll Payments	$170,000
Personnel Expenses	$160,000
Payments to Suppliers	$45,000
Supplies Expense	$48,000
Depreciation Expense	$12,000
Interest Expense	$6,000

Prepare an operating budget, cash budget, and capital budget for CBH for the month of March 2026.

2-27. Middleboro Township plans to order supplies every quarter of the year. It expects to receive the supplies in the quarter after they are ordered. It expects to use them the quarter after that and to pay for them the quarter after that. For example, if it orders supplies in the first quarter of the year, it will receive them in the second quarter, use them in the third quarter, and pay for them in the fourth quarter. The township pays salaries in the quarter that the employees work.

The township earns its income tax revenues in equal amounts throughout the year. However, it receives substantially more cash in April, when tax returns are filed. It plans to borrow $35,000 on a twenty-year, 5% annual interest note on the first day of the fourth quarter. Interest will be paid once each year at the end of the third quarter. Interest is paid only on outstanding debt—that which has not yet been repaid.

The town prepares its operating budget following the unique rules of modified accrual accounting used by governments. Under these rules expenses are recognized when the town receives goods or services and becomes legally obligated to pay for them. It does not matter if they have been used or not. Also, cash inflows or proceeds from long-term loans are treated as if they were revenues. Using the information from the following table, prepare an operating budget and a cash budget for Middleboro Township for the fourth quarter only. Assume the town has $300,000 in cash when the fourth quarter starts. (Hint: Interest expense is discussed in Chapter 5.)

	Jan.–March	April–June	July–Sept.	Oct.–Dec.	Total
Supply Orders	$300,000	$360,000	$390,000	$330,000	$1,380,000
Salaries	600,000	750,000	825,000	720,000	2,895,000
Income Tax Cash Receipts	600,000	600,000	1,200,000	600,000	3,000,000

2-28. Local Hospital (LH) has decided that it would like to send nurses to a local supermarket to provide a free health screening for interested supermarket customers. The screening will consist of measuring the individual's blood pressure and taking a drop of blood, which will immediately be tested for several critical indicators. The director of public relations at the hospital believes that 100 people will take advantage of the screening each day. The plan is to provide the screening every day for one week; thus a total of 700 screenings are expected. LH expects the supermarket to provide a $1,000 grant to help defray the costs of the program (because it will likely draw more customers to the store). LH anticipates the following expenses:

Test Equipment Rental	$500	For 1 week
Nurses	$50/hr	A total of 10 nurse hours/day for 7 days
Blood Tests	$1	Per individual tested

Create a special purpose budget for the program. Show revenues and expenses by line item, and show the expected profit or loss. If there is an expected loss, should LH necessarily abandon the project, or are there other factors that must be considered?[12]

2-29. Roche City has two major sources of revenues, property tax and sales tax, which are billed according to the schedule that follows.

2026	July	Aug.	Sept.	Oct.	Nov.	Dec.
Property Tax ($)	—	—	45,000,000	—	—	—
Sales Tax ($)	50,000	55,000	62,000	50,000	68,000	112,000

Traditionally, property tax revenues have been received in cash according to the following schedule:

40% in the first month following the billing date
20% in the second month
10% in the third month
10% in the fourth month
8% in the fifth month
5% in the sixth month
7% are not collected

The state collects the sales tax revenues and will transfer cash to the city on March 1, 2027, for the sales tax revenues earned in the last quarter of 2026.

Roche City is not planning any capital asset purchases during the next three months. Monthly cash disbursements for general operations are $3.7 million. Beginning cash balance for January 1, 2027, is $500,000. Roche City will borrow to ensure that the ending cash balance each month is at least $100,000.

Use this information to prepare a monthly cash budget for Roche City for January, February, and March of 2027.

2-30. Because of the downturn in the state's economy, the mayor of Stratton thinks that uncollectible taxes are likely to increase from 5% of total tax bills to 10% in the coming fiscal year. The total value of all the properties in the town of Stratton is $300 million, and the approved budget is $3.5 million. Properties are assessed at their full value. A total of $5 million worth of properties is exempt from taxation. To minimize tax increases in the coming fiscal year, the mayor and town council have decided to take $500,000 out of the town's rainy-day fund (a reserve used to meet short-term budget shortfalls) and apply that money toward the coming year's budget. How much does the town have to charge per $1,000 of assessed valuation to raise the needed $3.5 million? Show your calculations. You may round your answer to the nearest penny. Be sure to check your answer by multiplying the amount you propose billing by the expected tax-collections rate to show that the amount you expect to collect is enough to meet Stratton's fiscal needs.

2-31. Select from the choices that follow to answer the following questions:

a. increase
b. decrease
c. stay the same
d. cannot tell from the information given

1. If the amount of uncollectible school taxes increases, the mill rate that citizens must pay on their school taxes will ____.
2. If the value of taxable properties rises from $300 million to $310 million and the amount that the town needs to raise does not change, the mill rate that the town charges its citizens will ____.
3. If the value of tax-exempt properties decreased from $100 million to $75 million and the amount that the town needs to raise does not change, the mill rate that the town charges its citizens will ____.

2-32. River County is planning several capital acquisitions for the coming year. These include the purchase of two new garbage trucks at $150,000 each, one new bulldozer at $240,000, three new riding lawn mowers at $16,000 each, and construction of an activity center in the park for $650,000. The expected lifetime of the capital items is ten years for the garbage trucks, eight years for the bulldozer, five years for the lawn mowers, and forty years for the activity center. Prepare a capital budget for the items to be acquired, showing their estimated lifetimes and their per unit and total costs.

2-33. Zoo Extravaganza (ZE) is a not-for-profit organization. ZE took over the county zoo, with the provision that the county would provide a subsidy for its operations. The county provides $7,000 per month. The rest of the zoo's revenues come from admission charges, which are as follows: $20 for a family admission (the average family has four people), $3 per child in school groups, $5 per child ticket when not in a school group, and $8 per adult ticket.

Each ticket entitles the visitor to ride on the train around the zoo. However, only one third of all visitors actually ride the train.

The zoo expects the following number of visitors per month:

Visitor Type	Monthly Number of Admission Tickets
Adult	800
Child	950
Schoolchild	1,000
Families	300

The zoo has the following monthly expenses in four general areas:

Administration	$12,000
Zoo Staff	$10,000
Train Rides	$1 per person who rides the train
Maintenance	$1 per visitor

Create a monthly operating budget. Show revenues and expenses by line item, and show the expected profit or loss.

2-34. Draft a quarterly cash budget for ZE for the first two quarters of the coming year. Use only the information in this problem.

1. Interest is paid on the last day of the year and can be ignored in Quarters 1 and 2.
2. Annual expenses are $220,000 for administration and ZE staff (other than maintenance workers). Those costs are paid evenly throughout the year.
3. Assume the cash balance on January 1 is $5,000 and ZE policy is to have at least a $5,000 ending cash balance each quarter.
4. Train expenses are incurred in the same seasonal pattern as admissions and are paid with a one quarter lag. The budgeted annual expense for this year is $20,000. Last year the annual cost for the train was $18,000.
5. The cost of the maintenance crew is 20% of admissions revenue each quarter. Maintenance workers are paid in the quarter in which they work.
6. The total annual county grant of $84,000 is received on the last day of the fourth quarter of the year.
7. ZE collects all admissions in cash at the time of admission. Total admissions revenues are $180,000 for the year. The seasonal pattern of admissions is shown in the following table.

	Quarter			
	1	2	3	4
Admissions by Quarter	30%	25%	15%	30%

2-35. Prisons Counselors (PC) delivers counseling services to prison inmates for the state on a fee-for-service basis. It is preparing its cash budget for the month of March. Its operating budget reflects accrued fee-for-service revenues of $12,500, $13,000, and $14,000, respectively, for the months of January, February, and March. PC bills the state electronically at the end of each month for the services that it delivers to its fee-for-service clients. PC collects 60% of its fee-for-service billings in the month following the delivery of service with the remainder being collected in the second month after the delivery of services. What are PC's total cash receipts from the state for the month of March?

2-36. You are the executive director of a community service agency in Big City. Your operation is funded through a combination of cash contributions, federal government grants, and city contracts. Your revenue budget for the coming fiscal year is shown as follows.

Source of Revenue	Revenue Budget for the Coming Fiscal Year Q1	Q2	Q3	Q4
Contributions	$25,000	$35,000	$35,000	$50,000
Federal Grants	$250,000	$375,000	$350,000	$250,000
City Contracts	$240,000	$300,000	$320,000	$360,000
Total	$515,000	$710,000	$705,000	$660,000

You know from past experience that not all your revenue and support is collected when you earn it. Cash contributions are collected in the quarter they are pledged. Federal government grants are collected one quarter after you send the granting agency a bill. The city pays 25% of what it owes you one quarter after you send the bill. An additional 25% is collected from the city in two quarters, and the remaining 50% takes three quarters to collect. Starting with the preceding revenue budget, calculate the amount you can expect to collect in the fourth quarter of the coming fiscal year.

2-37. Re:Plate is a not-for-profit grocery store that buys unused edible food from restaurants and for-profit grocery stores and sells the food at below-market prices. It also offers cooking classes for a fee throughout the year. Its fiscal year is January 1–December 31. The following apply to FY 2026:

1. Re:Plate will begin the year with $21,000 in cash.
2. Re:Plate plans to buy one million pounds of food at $1.25 per pound in cash throughout the year. (Use "Food" as the line item in the budgets.)
3. Re:Plate expects to sell all its one million pounds of food in inventory it acquires throughout the year at an average price of $1.65 per pound. (Use "Grocery Sales" as the line item in the budgets.)
4. Re:Plate plans to offer three cooking classes per week throughout the year. Each class will have ten participants, each of whom will pay a $25 fee. (Use "Class Fees" as the line item in the budgets.)
5. Re:Plate will pay $10,000 per month in rent, up from $9,500 per month in FY 2025. Rent will be $10,500 per month in FY 2027. Re:Plate pays rent one month in advance.
6. Re:Plate's total payroll will be $210,000 in salaries, up from $180,000 in FY 2025. In addition to salary, Re:Plate's employees are paid benefits valued at 40 percent of their salaries. The benefits rate will be unchanged from FY 2025. Employees are paid monthly with a one-month lag. (Use "Salaries and benefits" as the line item in the budgets.)
7. Re:Plate will take out a $40,000 loan July 1. The loan will have an annual interest rate of 2%. An interest payment and a principal repayment of $10,000 will be due December 31.
8. Re:Plate will use the loan to purchase a new forklift that will have a useful life of ten years and a salvage value of $5,000. Re:Plate also owns computer equipment it purchased in 2024 for $50,000; the equipment has no salvage value and a useful life of five years. Prepare an annual operating budget and a semiannual cash budget (showing the first half of the year, the second half of the year, and annual amounts in three side-by-side columns) for FY 2026. (Hint: Interest expense and depreciation expense are discussed in Chapters 5 and 10, respectively.)

2-38. The county has an initiative for students in underperforming schools. To get funding, schools provide each student with eight 2-hour group tutoring sessions each month. Also, parents must agree to pay $10 per month for each child they register for the program. The county will pay each school $200 per enrolled child per month.

Schools must provide one tutor for every five students enrolled in the program at a cost of $50 per hour at a teacher's home school or $60 per hour if the teacher has to commute from another school in the system.

Schools that participate also need to acquire a site license for a self-study computer program at a cost of $2,400 per year regardless of the number of students. Schools also incur a cost of $1.50 per child, per tutoring session, for workbooks that are tied to the self-study program.

Generally, the county takes one month to pay bills submitted by schools. Parents pay all tuition bills at the beginning of each month. Participating teachers are paid for all after-school programs at the end of each month. The full cost of the software must be paid by the end of the first month of the program. Workbooks are paid for in the month they are used.

You are the budget manager for Typical County School (TCS). Five teachers in your school have agreed to be tutors. Because you expect to need fifteen tutors by the end of the year, you will also use ten teachers from other schools as needed. Your calculations indicate an expected twenty-five students in the program during the first month it is offered, forty-one in the second month, and fifty-two in the third month. As budget manager,

1. prepare operating budgets for each of the first three months of the program;
2. summarize the three monthly budgets into a quarterly operating budget; and
3. Starting from a zero cash balance, prepare a cash budget for the first quarter (three months) of the program. You do not have to prepare monthly cash budgets.

2-39. Marquoya College[13]

Part I

Marquoya College (MC) is a medium-sized private school located in the Midwest. In the past, MC administrators established a budget for the next academic year by adding a specific percentage (e.g., 6%, 8%) to the tuition revenue and operating expenses. This year MC has asked for your assistance in developing its budget for the next academic year. You are supplied with the following data for the current year:

Enrollment	4,300 students
Tuition	$3,300/year
Full-time Faculty	250 (72% tenured)
Fees	$280/year
Average Faculty Salary	$36,000/year
Full Tuition-only Scholarships	400 students

For the next academic year, enrollment is expected to increase by 300 students with each student taking an average of thirty-two credit hours. Tuition will increase by $100 per year. Prepare a schedule computing the next academic year's tuition and fee revenue budget. Explicitly show the effect of scholarships.

Part II

The additional students will require MC to hire twenty adjunct faculty members. Each adjunct will teach eighteen credit hours and be paid at the rate of $750 per credit hour. Full-time faculty members will receive a 5% pay increase. Additional merit increases to be awarded to individual faculty members will amount to $280,000.

Prepare a schedule computing the next academic year's budget for faculty salaries. The payroll budget should reflect payroll taxes using a rate of 10%.

Part III

The current budget is $1.2 million for operation and maintenance of plant and equipment, including $190,000 for salaries and wages. Experience of the past three months suggests that the current budget is realistic. However, expected increases for next year are $10,000 in salaries and $50,000 in other expenditures for maintenance of plant and equipment.

The IRS has determined that MC has unrelated business income. In the past year, MC paid $48,000 in federal income taxes and a penalty of $2,000. MC's administrators think that proper allocation of costs and timely payments to the IRS will result in a total tax liability of $36,000.

Estimates for other costs include the following:

Mortgage Payments	$ 264,000 (reducing principal by $100,000)
Administrative and General	1,440,000 (including salaries of $1,200,000)
Library	1,800,000 (including salaries of $1,000,000)
Health and Recreation	750,000 (including salaries of $300,000)
Athletics	320,000 (including salaries of $60,000)
Insurance and Retirement Benefits	548,000
Capital Improvements	1,300,000

Where applicable, use a payroll tax rate of 10%.

Anticipated revenues, other than tuition for the next academic year, are as follows:

Endowment Receipts (e.g., Interest, Dividends)	$514,000
Net Income from Auxiliary Services	$538,000
Athletics	$1,580,000

MC's remaining source of revenue is an annual alumni support campaign. Last year the alums were generous (MC's basketball team was ranked high throughout the cage campaign) and contributed more than $600,000.

MC borrowed $200,000 from the Golden Dome Bank for summer operations on June 15. The principal plus interest (at an annual rate of 12%) is to be paid on September 15. On the basis of the tuition and fee revenue budget and faculty salaries budget computed in parts I and II, prepare a schedule computing the amount that must be raised during the annual support campaign to cover the expenditures budgeted.

Part IV

Using anticipated alumni support of $750,000, prepare a cash budget for the first quarter (September, October, November) of the MC fiscal year. (Round all calculations to the nearest hundred dollars.) The following patterns of cash flows are anticipated:

	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.–Aug.
Tuition Revenue	20%	—	15%	5%	30%	15%	15%
Fee Revenue	50%	—	—	—	50%	—	—
Endowment Income	25%	—	—	25%	—	—	50%
Net Income from Auxiliary Services	10%	10%	10%	10%	10%	10%	40%
Athletic Revenue	10%	—	50%	10%	10%	5%	15%
Alumni Support	2%	2%	12%	25%	6%	3%	50%
Faculty Salaries	10%	10%	10%	10%	10%	10%	40%
Operation and Maintenance of Plant and Equipment	8%	8%	10%	10%	10%	8%	46%
Insurance and Retirement	10%	10%	10%	10%	10%	10%	40%
Athletic Expenditures	10%	5%	10%	10%	15%	10%	40%
Capital Improvements	—	80%	—	10%	—	—	10%
Federal Income Tax	—	—	—	—	25%	25%	50%
All Others	12 equal receipts/disbursements						

MC must maintain a cash balance of $3,000. Financing can be arranged at the Golden Dome Bank at a rate of 8%. Borrowing occurs in $1,000 increments. All loans are repaid as soon as possible, but a minimum of one month's interest is charged. Estimated cash on September 1 is $3,700.

Extended Problem (2-40)

Denison Specialty Hospital–Part I

Denison Specialty Hospital is planning its master budget for the coming year. The budget will include operating, capital, cash, and flexible budgets. The hospital is noted for its three fine programs: oncology (cancer), cardiac (heart), and rhinoplasty (nose jobs).

Section A

The managers at Denison have been busy working. They have reviewed past records and considered changes in competition, the general economy, and overall medical trends. Using past charges and anticipated rates of medical inflation, they have also made a first attempt at setting their prices.

Based on a thorough review and discussion of these data, they have projected that next year they will have 240 patients. They expect 120 oncology patients, eighty cardiac patients, and forty rhinoplasty patients.

The charge, or list price, for oncology patients will average $50,000. Cardiac patients will be charged an average of $40,000 and rhinoplasty patients $25,000. However, those charges often are not the actual amount ultimately received.

The amount the hospital receives depends on whether patients pay their own hospital bills or have health-care insurance. Assume that private insurance companies pay the full charge or list price. However, Medicare and Medicaid have announced rates they will pay for the coming year as follows: oncology patients $40,000, cardiac patients $30,000, and rhinoplasty patients $10,000. Self-pay patients are supposed to pay the full charge, but generally 25% of Denison's charges to self-pay patients are not collected. Expected amounts that will not be collected reduce the amount of revenue reported. No payment for charity care is ever received, and **charity care is not shown as a revenue or expense**.

The payer mix is as follows:

	Private Insurance	Medicare/Medicaid	Self-pay	Charity
Oncology	30%	50%	10%	10%
Cardiac	20%	60%	10%	10%
Rhinoplasty	10%	20%	60%	10%

Gift shop revenue is projected to be $120,000 for the current year and is expected to remain the same. However, this revenue will increase or decline in proportion to changes in patient volume.

Denison has an endowment of $1 million. It is invested as follows:

$500,000 in 6% U.S. government bonds that pay interest annually
$250,000 in AT&T stock, which pays a dividend of 8% annually
$250,000 in growth stocks that pay no dividend

Section A Requirements:

1. Calculate patient revenue on an accrual basis for the coming year. Subdivide revenue by program, and within each program subdivide it by type of payer.
2. Calculate endowment revenue on an accrual basis for the coming year.
3. Prepare a revenue budget on an accrual basis, including all sources of revenue discussed previously. The revenue budget does not have to show all the detail from requirements 1 and 2 but should show each major source of revenue, such as patient services and endowment.

Section B

The hospital expects to employ workers in the following departments:

	Radiology	Nursing	Administration	Total
Managers	$100,000	$200,000	$200,000	$500,000
Staff	1,900,000	4,200,000	300,000	6,400,000
Total	$2,000,000	$4,400,000	$500,000	$6,900,000

Supplies are expected to be purchased throughout the year for the departments as follows:

	Total
Radiology	$360,000
Nursing	160,000
Administration	20,000
Total	$540,000

Assume that *all* supply use varies with the number of patients.

Denison currently pays rent on its buildings and equipment of $300,000 per year. Rent is expected to be unchanged next year. The rent is paid $75,000 each quarter.

To better serve its patients, Denison would like to buy $500,000 of new oncology equipment at the start of next year. It would be paid for immediately upon purchase. The equipment has a five-year life and would be expected to be used evenly over that lifetime. Although the capital budget would normally include justification for why the equipment is needed, it is sufficient for our purposes to know that the capital budget for Denison is $500,000 and the equipment to be purchased has a five-year useful life. It will have no value left at the end of the five years. Denison charges the cost of its capital acquisitions on a straight-line depreciation basis. That means that the cost is spread out over the useful life with an equal share being charged as an expense, called depreciation expense, each year.

Section B Requirements:

1. Calculate an expense budget on an accrual basis for the coming year. The expense budget does not require detailed information by program or department but should show each type of expense, such as salaries and supplies. Be sure to consider the impact of capital acquisitions on the expense budget.
2. Combine the revenue (Section A) and expense budgets to present an operating budget for the coming year.

Note: Part II of this extended problem appears at the end of Chapter 3.

Notes

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.
2. Most organizations do not actually collect all of the money that is owed to them for goods or services they have provided. The amounts that are never collected are referred to as uncollectible accounts, implicit price concessions, or bad debts. Under accrual accounting the operating budget would show the full amount earned less the portion that it expects it will not be able to collect.
3. Alan Walter Steis, *Financial Management in Public Organizations* (Pacific Grove, CA: Brooks/Cole, 1989), 146.
4. Steis, 151.
5. Steis, 146.
6. Steis, 153.
7. Donald Axelrod, *Budgeting for Modern Government* (New York: St. Martin's Press, 1988), 12

8. Often audits seek to determine if financial statements have been prepared in accordance with rules that are referred to as Generally Accepted Accounting Principles (GAAP). See Chapter 9 for further discussion of GAAP.
9. John L. Mikesell, *Fiscal Administration: Analysis and Applications for the Public Sector*, 9th ed. (Boston: Wadsworth, Cengage Learning, 2014), 68.
10. Martin Ives, Joseph R. Razek, and Gordon A. Hosch, *Introduction to Governmental and Not-for-Profit Accounting*, 5th ed. (Upper Saddle River, NJ: Pearson Education, 2004), 71.
11. Ives, Razek, and Hosch, 81.
12. This problem and problems 2-28, 2-32, and 2-33 are adapted from problems written by Dwight Denison.
13. This problem was written by Ken Milani and Jim Gaertner. Used with permission.