

Financial Strategy for Public Managers

Fourth Edition

Sharon Kioko and Justin Marlowe

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FOREWORD

There are many fine textbooks on public financial management. Each does certain things well, but in our view, none covers all the concepts, techniques, and analytical tools that today's public policy and administration graduate students need to put their passion into action. This book is our best attempt to weave that material together in a fresh, robust, concise, and immersive way. We also believe the time is right to bring to the market a free, open-source treatment of this critically important subject.

At the University of Washington and the University of Chicago, we use this text for a variety of quarter-length introductory courses on public finance, budgeting, and financial management. We believe it's also suitable for a similarly structured semester-long course. Sections of the text might also be suitable for other courses often found in Master of Public Administration, Master of Public Policy, and other programs. Chapters 2 and 3 would be appropriate for courses on governmental accounting, debt management, or non-profit financial management. Chapters 4 and 5 work well for an applied public or non-profit budgeting course.

The first time we co-taught "Public Financial Management and Budgeting," we quickly realized that we approached the course in similar ways. That shared thinking is partly the result of our shared experiences with some exceptional teachers and scholars. They include, in no particular order: the late William Duncombe (formerly of Syracuse University); Bart Hildreth and Ross Rubinstein (Georgia State); Katherine Willoughby (University of Georgia); Craig Johnson (Indiana University); Jerry Miller (Arizona State University); and the late Dwight Denison (formerly of University of Kentucky).

We want to thank Dean Emeritus Sandra Archibald, Evans School Dean Jodi Sandfort, and Harris School Dean Kate Baicker for their commitment to excellence in the teaching of public finance, budgeting, and financial management. Without the support of Apurva Ashok (Rebus Foundation), Lauren Ray (University of Washington Libraries), and Sophia Keskey (Evans School of Public Policy), this project would not have been possible. Lastly, we are indebted to our students, who, through their thoughtful suggestions and criticisms, helped shape and enrich this project.

Sharon Kioko
Daniel J. Evans School of Public Policy & Governance
University of Washington
skioko@uw.edu

Justin Marlowe
Harris School of Public Policy
University of Chicago
jmarlowe@uchicago.edu

INTRODUCTION

In 2015, Mark Zuckerberg, founder of Facebook, launched a plan to give away most of his \$45 billion fortune. Along with his wife, Priscilla Chan, he announced the creation of a philanthropic organization known as the “Chan-Zuckerberg Initiative.” This “Initiative” defies conventional labels. At one level, it is similar to traditional non-profit organizations. It can deliver social services, participate in public policy debates, and partner with other non-profits. Like traditional philanthropic foundations, it plans to provide grants in key policy areas, including education reform and social justice.

But the Initiative is also decidedly non-traditional. It is organized as a for-profit limited liability corporation. That means when it wants to, it can do many things non-profits and governments cannot. It can invest money in other for-profit entities. It can fund election campaigns. It can manage and invest money on behalf of other non-profit and for-profit organizations. So, the important question around Chan-Zuckerberg is not what will it do, but rather, what won't it do? With \$45 billion at its disposal and few, if any, limits on how to spend it, the possibilities are endless.

Some are calling this “philanthrocapitalism.” Chan-Zuckerberg is the largest and most visible recent example. But there are many others. If you have ever bought a sweater at Patagonia, worn a pair of TOMS shoes, or used a shot of insulin from Novo Nordisk, you have participated in philanthrocapitalism. These are all for-profit companies with a social purpose hard-wired into their mission. This also works from the other direction. Strange as it sounds, IKEA – whose founder Ingvar Kamprad was once the wealthiest person in the world – is controlled by a charitable family foundation.

Maybe you didn't think public finance has anything to do with Fair Trade Certified™ fleece vests or the FJÄLKINGE shelving unit. Turns out it does.

Philanthrocapitalism brings the glamour and prestige of big business to the decidedly un-glamorous work of feeding the hungry, housing people experiencing homelessness, and the other essential efforts of governments and non-profits. That's important. But even more important, it's forced us to re-think what managing “public” money means.

Showtime's hit show *Billions* is the story of a hedge fund that operates in the shadowy underworld of finance. That fund – known as Axe Capital, for its founder Bobby Axelrod – will do anything to turn a profit. Its traders buy and sell stocks on inside information, bribe regulators, and spread market-moving rumors, among many other nefarious tactics.

Season 2 features a compelling storyline ripped from the proverbial public finance headlines. Axe learns through a back channel that the Town of Sandicot, a long-struggling upstate New York town on the verge of bankruptcy, is about to be awarded a state license to open a new casino.

Axe sees an opportunity. When a government is on the verge of bankruptcy, investors steer clear of

it. As a result, Sandicot's municipal bonds (a form of long-term loan) are available for pennies on the dollar. Axe believes the new casino will drive an economic recovery, and once that recovery is underway, investors will look to buy up Sandicot's bonds. So, he decides to get there first. He "goes long" and buys several hundred million of Sandicot municipal bonds.

But then the story takes an unexpected turn. Word of the Sandicot play leaks out, and Axe's opponents persuade the State to locate the casino in another town. At that moment, Axe faces a difficult choice: Sell the bonds and lose millions or force Sandicot to pay back the bonds in full. Unfortunately, Sandicot can repay only if Axe forces it to enact savage cuts to its police, firefighters, schools, and other basic services. Axe is leery of the bad press that will surely follow a group of billionaire hedge fund managers profiting at the expense of a struggling town.

When asked for their opinion, a superstar Axe analyst named Taylor Mason – the first gender non-binary character on a major television show – says:

"In many ways, a town is like a business. And when a business operates beyond its means, and the numbers don't add up, and the people in charge continue on heedless of that fact, sure that some Sugar Daddy – usually in the form of the federal government – will come along and scoop them up and cover the shortfalls, well, that truly offends me. People might say you hurt this Town, but, in my opinion, the Town put the hurt on itself. Corrections are in order. There's a way to make this work, and that way is hard but necessary... Once we do this, the town will face that challenge and come out stronger. Or it will cease being. Either result is absolutely natural."

Governments and non-profits tend to have a "retrospective" view of money. To them, an organization's money is well-managed if it stays within its budget, complies with donors' restrictions, and completes its financial audit on time. To them, bigger questions like "Is this program working?" or "Does this program deliver more benefits than it costs?" are best answered by elected officials and board members. In their view, if we mingle the different sectors' money, taxpayers will never know what they get for their tax dollars, and elected officials and board members won't know if the programs they worked so hard to create and fund are delivering on their promises. To public organizations, financial accountability has often meant looking back to ensure that public money was spent according to plan.

Zuckerberg and many others who now operate in the public sector see public money in "prospective" terms. To them, public money is a means to an end. It's how we'll end racial disparities in public education, cure infectious diseases, close the gender pay gap, and pursue other lofty goals. These folks are not particularly concerned with how government tax dollars differ from charitable donations or business profits. If money can move an organization closer to its goals, regardless of where that money comes from, why not add it to the mix? They don't think of financial contributions as a way to divvy up credit for a program's success. They want to know how their money was spent, but far more importantly, they want to know what it accomplished.

The opposite is also true. Taylor Mason and many others who share their views also see public money in "prospective" terms. But instead of thinking about what the public sector could accomplish, they also believe no public sector organization is "too big to fail." If a local government like Sandicot is no longer accomplishing its mission, they argue, it should cease to exist.

Both these perspectives – “philanthrocapitalism” and “government is like a business” – are significant departures from public financial management’s status quo. They’re also why public organizations have tended to segregate themselves into “money people” and “everyone else.” Money people tend to see the world differently.

And to be clear, both these perspectives illustrate a much broader recent trend: blending the financial lines across the sectors. Many non-profits now operate profitable lines of business that subsidize other services they provide for free. Governments around the world have created for-profit corporations that allow private sector investors to build, operate, and maintain public infrastructure like bridges, subways, and water treatment facilities. Charitable foundations of all sizes now act as “Angel Investors.” They buy stock in small start-up companies that develop products to improve the quality of life in the developing world. Many of those investments have turned a handsome profit that, in turn, subsidized other, far-less-profitable endeavors.

Philanthrocapitalism and “government, like business,” are also animated by pressure to do more with less. For roughly 50 years, taxpayers around the world have said no to new taxes but yes to a steady expansion of the size and scope of government. They have demanded more spending on health care, education, environmental conservation, and other services but left unclear how to pay for it. They have allowed their governments to borrow record amounts of money but denied them the financial means to repay that debt. Many governments today are simply maxed out. They have little or no new money to commit to innovative programs that philanthrocapitalists like Bill Gates, Mark Zuckerberg, and others would like to see.

These trends – blurring of the sectors, emphasis on outcomes, scarce government resources – are redefining what it means to manage public money.

You got into public service because you want to make a difference. Maybe, like Mr. Zuckerberg, you want to tackle big, complex public problems. Maybe you want to make governments and non-profits work just a bit more efficiently. Maybe you think government should do a lot more in areas like health care, education, and transportation. Maybe, like Taylor Mason, you think government should get out of the way and make room for non-profits and for-profits. Regardless of your goals, you’ll need to speak the language of public financial management to make that difference. You’ll need to translate your aspirations into cost estimates, budgets, and financial reports. You’ll need to show how an investment in your program/product/idea/initiative/movement will produce results. You’ll need to understand where public money comes from and where it can and can’t go. You probably didn’t get into public service to manage money but in today’s rapidly changing public sector,

We’re all money people now!

And the opposite is also true. In today’s public sector, money people must also step outside of their comfort zone. They must be able to communicate with program managers, board members, and many other stakeholders with whom they don’t traditionally interact. They must help others translate their ideas into the language of finance. As a public manager, a big part of your job will be learning to inspire your money people to step far outside of their comfort zone in the name of accomplishing your organization’s goals.

WHAT IS FINANCIAL STRATEGY?

Money is to public organizations what canvas is to painting. The painter wants to bring their artistic vision to life on the canvas. But to do this, they must work within the confines of that canvas. If the canvas is too small, too rough, or the wrong shape, the painter must adapt their vision. If they stray too far from their vision, they must know when to find a different canvas.

As a public servant, you are like a painter. You know what your organization wants to accomplish, but you must bring those accomplishments to life on its financial canvas. Every organization's financial canvas is a bit different. Some have many revenue streams that produce more than enough money, while others depend on a single revenue source to generate just enough money to keep the organization running. Some have broad legal authority to raise new revenue and borrow money, while others must get permission from their board, taxpayers, or other stakeholders at every step. Some have sophisticated financial experts to produce budgets and manage money, while others have no such expertise.

It's not a problem that each public organization's financial canvas is different from the rest. In fact, those differences are an essential part of what makes public financial management an exciting and dynamic field of study. The problem, however, is that many great policies and programs fail because they're painted on the wrong financial canvas. Public organizations often take on policy challenges without the right financial tools, authority, and capacity. By contrast, some organizations are too modest. They have the tools, authority, and capacity to take on big challenges, but for various reasons, they don't. Financial strategy is how public organizations use their financial resources to accomplish their objectives. It's how they put their organization's vision to its financial canvas.

All public organizations must confront limits on the amount and scope of financial resources they can access. So, in practical terms, a financial strategy is often about tempering our expectations to match what our financial canvas can support. It's about analyzing a program's cost structure to make it more efficient, scaling back its goals and objectives, or finding partner organizations to help launch it. Sometimes, strategy means finding a new canvas. That might mean forming a new organization, re-purposing an existing program, or recruiting a new foundation or venture capitalist to invest. This book tells you how to understand the many different types of canvases available to you and the many different ways to put your organization's vision to one of those canvases.

TECHNIQUE SUPPORTS STRATEGY

We organized this book around a simple idea: technique supports strategy. There are many fine textbooks on public financial management, and almost all of them focus on technical skills. For more than a generation, students of this subject have learned how to forecast revenues, build budgets, record basic transactions in an organization's financial books, and many other useful skills. At the same time, students have rarely been asked a far more important question: Where and how should they apply those skills? We believe technical skill is useful only if it informs actual management decisions. A cost analysis is useful only if it tells us whether and how to launch a new program. Financial statement analysis is a powerful tool because it can inform when to build a new building, start a capital campaign, or invest unused cash. Budget variance analysis is important because it tells program managers where to focus their attention. And so forth. We present these and other

techniques, but more importantly, we try to explain how those techniques can and should inform crucial management, strategy, and policy decisions.

Strategic thinking is, at some level, about “knowing what you don’t know.” It’s about stepping outside of your own experience. It’s about looking into your organization’s future. It’s about putting yourself in your stakeholders’ shoes. That’s why one of the most valuable tools in financial strategy is asking the right questions. No one can be an expert on all things financial. But if you can ask the right questions and access the right expertise, you can know enough to drive your strategy.

That is why one of the most important techniques in public financial management is asking good questions. This book is littered with questions. Each chapter begins not with learning objectives, but with the kinds of questions managers ask and how the information, conceptual frameworks, and analytical tools from financial management can help answer those questions. It includes exercises to help you refine your financial management technique. But more importantly, it has cases and other opportunities for you to apply that technique to support a genuine financial strategy.

Financial strategy is not sector-specific. What works in the for-profit sector might work in non-profits or governments, and vice versa. And as sector distinctions matter less, financial strategy’s origins also matter less. That is why most of the discussion in this book is predicated on the idea that all governments, non-profits, and “for-benefit” organizations (i.e., for-profit organizations with an explicit social purpose) are mostly alike. You will see “public organization” and “public manager” used often. These are generic terms to describe people who interact with the financial strategy in these types of organizations. To be clear, “public manager” includes policy analysts, community organizers, for-profit contractors, and anyone else who has a stake in a public organization’s finances. Where necessary and appropriate, you’ll see discussions highlighting how each sector’s technical information, legal environment, and strategic directions differ. But for the most part, this text assumes that public organizations have a lot in common.

HOW THIS BOOK IS ORGANIZED

First and foremost, this is a book about people and organizations. To many of us, finance and budgeting are abstract subjects. They are numbers in a spreadsheet, but not much more.

In reality, public financial management is how real public servants in real public organizations bring their passions to life. That is why all of the technical information is presented in the context of specific people, organizations, and strategies. Throughout this book, you will find lots of illustrations and examples drawn from real public organizations.

The first chapter is titled “How We Pay for the Public Sector.” It covers where public organizations’ money comes from and where it goes. It also highlights some of the pressing challenges facing public organizations – namely shrinking public resources and burgeoning mandatory expenditures – and how those challenges present tremendous opportunities for entrepreneurial public managers.

Each of the subsequent chapters covers a bundle of tools that public financial managers use to inform financial strategy. The second chapter covers the basic financial statements. Financial statements are an essential and often overlooked tool to understand an organization’s financial story. This chapter

introduces those statements, the information they contain, and the questions they help public sector managers ask and answer.

Chapter 3 is about financial statement analysis. If financial statements tell an organization's financial story, financial statement analysis is the annotated bibliography of that story. It is a tool to understand the specific dimensions of an organization's financial position, to place that position in an appropriately nuanced context, and to identify strategies to improve that financial position in both the near-term and long-term.

To truly understand the numbers in the financial statements – and how those numbers might change as an organization pursues different financial strategies – you must also understand the core concepts of accounting. To that end, the fourth chapter is an applied primer on core accounting concepts like accruals, revenue and expense recognition, depreciation and amortization, and encumbrances. These concepts and their application to actual financial activity are collectively known as “Transaction Analysis.”

Chapter 5 is about Cost Analysis. Many public organizations need help to meaningfully answer a simple question: What do your programs and services cost? They struggle not because they are lazy or inept but because it is challenging to measure all the different costs incurred to produce public services and then express those costs in an intuitive way. It is even more challenging to think about how those costs change as the amount of service changes or as the scope of a service expands or contracts. It is challenging, but it is also essential. Every successful public program ever devised was designed with a careful eye toward its cost structure. In this chapter, you will learn the different types of costs, the core concepts of cost behavior, and how to think about ways to improve an organization's financial position given its cost behavior.

Chapter 6 covers Budgeting. A public organization's budget is its most important policy statement. It is where the mission and the money connect. Budgeting is, at one level, a technical process. It demands solid cost analysis, revenue and expense forecasting, and clear technical communication. But more importantly, it's a political process. It is how policymakers bring their political priorities to life and shut down their opponents' priorities. It is how the media and taxpayers hold public organizations accountable. It is where sophisticated public managers can advance their priorities. This chapter focuses on budgeting as a technical process, emphasizing the different types of budgets and the legal processes by which budgets are made. But it also covers some of the common political strategies that play out in the budget process and how public managers do and do not engage those strategies. The discussion of those strategies is loosely organized around concepts borrowed from the burgeoning field of behavioral economics, such as loss aversion and the “endowment effect.”

At the outset, it is also worth highlighting what this book does not cover:

- Unlike other textbooks in this space, we do not give special attention to financial management in healthcare organizations. Healthcare financial management has much in common with public financial management. But recent trends in the former – especially the Medicare Modernization Act, the Affordable Care Act (“Obamacare”), and the collapse of the municipal bond insurance market – have made it too distinct to cover in a coherent way within the framework of this book.

- We gloss over government budgeting systems and processes. We cover the steps outlined in law that governments are supposed to follow to arrive at a budget. But for roughly a decade now, the actual budget processes in Washington, D.C., and many state governments have been quite different from what's prescribed in law. Terms that used to describe deviations from that process, like "continuing resolution," "sequestration," "sweeps," and "recissions," now seem like parts of that process. That's why it seems silly to devote much attention to the budget process. Instead, we treat budgeting as where money, politics, and priorities come together in predictable and unpredictable ways.
- Financial managers find themselves in the throes of transformational changes in public organizations. They are asked to push the boundaries of what traditional procurement and contracting processes will allow. They are often asked to implement massive new information technology projects. They find themselves leading new initiatives around "evidence-based decision-making," "lean management," and "performance benchmarking," among others. Woefully, we do not have time or space to devote to these processes. We hope to cover these topics in future iterations of this text.

HOW WE PAY FOR THE PUBLIC SECTOR

WHERE THE MONEY COMES FROM AND WHERE IT GOES

Managers need to know where public money comes from and where it goes. That information can answer important questions like:

- What revenue options are available to governments? Non-profits?
- What are the advantages and disadvantages of various revenue sources with respect to efficiency, equity, fairness, and other goals?
- How will the US federal government's financial challenges shape the financial future of the public sector?
- How, if at all, will governments address the challenges of income and racial inequality?

In January 2010, the United States Department of Justice (DOJ) received a formal civil rights complaint from a local community organization in Ferguson, Missouri. In their complaint, they accused the Ferguson Police Department of aggressive and biased policing tactics, including large numbers of traffic stops, searches, seizures, and arrests in the city's African American communities. DOJ officials corroborated the report with the Missouri Attorney General's office, which had also received several similar complaints throughout the previous five years. Both offices agreed to monitor the situation.

On August 9, 2014, Michael Brown, an African American teenager, and resident of Ferguson, was shot and killed by a Ferguson police officer who was investigating a nearby robbery. Ferguson police officials drew sharp criticism for the incident and their management of the subsequent investigation into potential police misconduct. Several weeks later, a grand jury declined to indict the police officer. In their view, the evidence suggested the police officer had reason enough to consider Brown as a potentially dangerous suspect.

The shooting sparked violent protests across the United States. Ferguson residents said the shooting was just the most recent example of the racist policing they had pointed out to federal and state officials years earlier. They implored Attorney General Eric Holder to immediately open a DOJ civil rights investigation into the Ferguson Police Department. Holder said his office would gather as much information as possible but cautioned everyone that anecdotes and demographics are insufficient to prove an accusation of biased policing. For several weeks, the country anxiously awaited word on what DOJ would do next.

On September 20, 2014, the DOJ opened a formal civil rights investigation. The report from that

investigation was released in March 2015. It excoriated the Ferguson Police Department and the Ferguson City Council for actively and passively encouraging the sort of aggressive policing that Ferguson residents had decried. But perhaps even more importantly, it explained that the most compelling evidence of biased policing was not arrest records or police reports. *It was Ferguson's budget.* The report said, "Ferguson's law enforcement practices are shaped by the City's focus on revenue rather than public safety needs." It documented a recent trend toward raising new city revenues through aggressive enforcement of fines and fees. Ferguson generated more than \$2.5 million in municipal court revenue in fiscal year 2013, an 80 percent increase from only two years prior. In all, fines and forfeitures comprised 20 percent of the city's operating revenue in fiscal year 2013, up from about 13 percent in 2011. By comparison, other St. Louis suburbs relied on fines and fees for no more than six percent of operating revenue. This budget strategy legitimized and even encouraged Ferguson's law enforcement and court officials, most of whom were not racists, to pursue aggressive policing against Ferguson's majority African American community.

The takeaway here is clear: **where a public organization gets its money says a lot about its priorities.** In Ferguson's case, choices about where to get revenue led to a nationwide social movement.

LEARNING OBJECTIVES

After reading this chapter, you should be able to:

- Identify the revenue sources used by the federal, state, and local governments.
- Show how similar governments pay for similar services in quite different ways.
- Identify some of the "macro-challenges" that will shape public organizations' finances well into the future.

Governments across the United States do the same basic things. Cities and towns primarily maintain roads, plow snow, keep neighborhoods safe, prevent and fight fires, and educate children. County governments run elections, care for the mentally ill, and prevent infectious diseases. State governments provide schools with funding for education, coordinate health care for the poor, incarcerate prisoners, and operate public universities and community colleges. The national – or "federal" – government regulates trade and commerce, defends our borders, and pays for health care for seniors.

At the same time, governments are remarkably dissimilar in how they pay for and deliver these services. Some rely on a single tax source for most or all of their revenue. Others draw on many different revenue sources. Some deliver their services with the help of non-profits, private sector contractors, and other stakeholders. Others engage outside entities infrequently, if at all. Some citizens want their government to deliver many different high-quality services. Others want their government to do as little as possible.

These choices about how governments pay for their services, how much they provide, and how they ultimately deliver those services matter a lot to citizens. For instance, if a city government

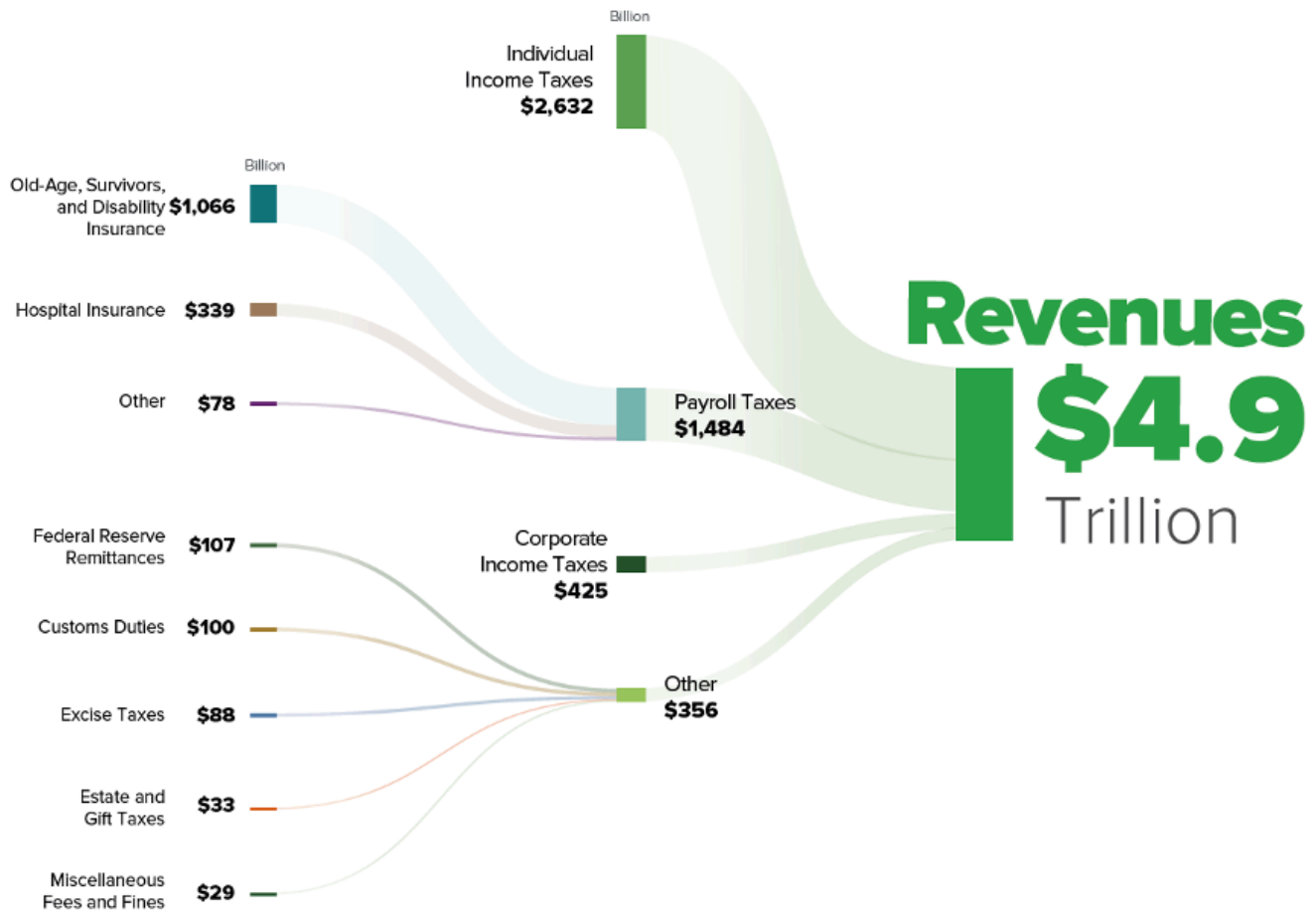
depends mostly on property taxes, its leaders might have the incentive to emphasize services that benefit property owners, such as public safety and sidewalks, and worry less about services more likely to benefit those who do not own property, like public parks or housing people experiencing homelessness. In some regions, governments pay non-profit organizations to deliver most or all essential services in areas like foster care, child immunizations, and assisted living for seniors. For those who use those services, the quality of service they receive can depend a lot on which non-profit delivers the service or manages their case.

So, at a high level, governments look the same. But if we examine them more carefully, we see they vary greatly in where their money comes from and where it goes. That variation, and its implications for citizens, is a key part of the study of public finance. This chapter is a basic overview of where governments get their money, where they spend it, and some of the financial challenges they will likely face.

THE FEDERAL GOVERNMENT

The national government – also known as the “federal government” – is one of the largest and most important employers in the United States. Every soldier in the military, customs agent at an airport, and astronaut at NASA (the National Aeronautics and Space Administration’s acronym) works for the federal government. And so do many, many others. In 2022, the federal government spent just under \$6.3 trillion and employed an estimated 4.3 million people directly and millions indirectly as government contractors and grant employees. For the past decade or so, federal government spending has accounted for roughly one-quarter of the U.S.’s entire economic output – otherwise known as its gross domestic product (GDP).

Federal government revenues in FY 2022 were \$4.9 trillion; 84 percent was from two sources –individual income tax and payroll taxes.



Source: Congressional Budget Office (2023) "Revenues in Fiscal Year 2022"

The federal government collected just over \$2.6 trillion in individual income taxes in FY 2022. The tax paid on income is determined by applying a tax rate to taxable income with allowances for tax preferences.

Taxable income is the amount of income (e.g., wages, interest and dividend income, partnership and business income (or loss), farm income, pension income, rents, royalties, and Social Security benefits) subject to tax after deductions and exemptions. The federal government offers a *standard deduction* that all taxpayers can claim. The reduction of taxable income varies by filer type (e.g., \$13,850 for single filers, \$27,700 for married filers filing jointly, and \$20,800 for heads of household in 2023). Beyond that *standard deduction*, eligible taxpayers can claim hundreds of other exemptions, deductions, credits, and other tax benefits related to home ownership, retirement savings, health insurance, investments in equipment and technology, and dozens of other areas. The federal government offers these preferences to encourage taxpayers to save for retirement, buy a home, invest in a business, or participate in other types of economic activity. The *tax rate* is the amount of tax paid per dollar of taxable income. For 2023, the federal tax code has seven different rates that are applied across levels of taxable income (also known as tax brackets). Those *statutory rates* ranged from 10 percent on individual annual income up to \$11,000 to 37 percent on annual income over \$578,125 (\$693,750 for married individuals filing joint returns).

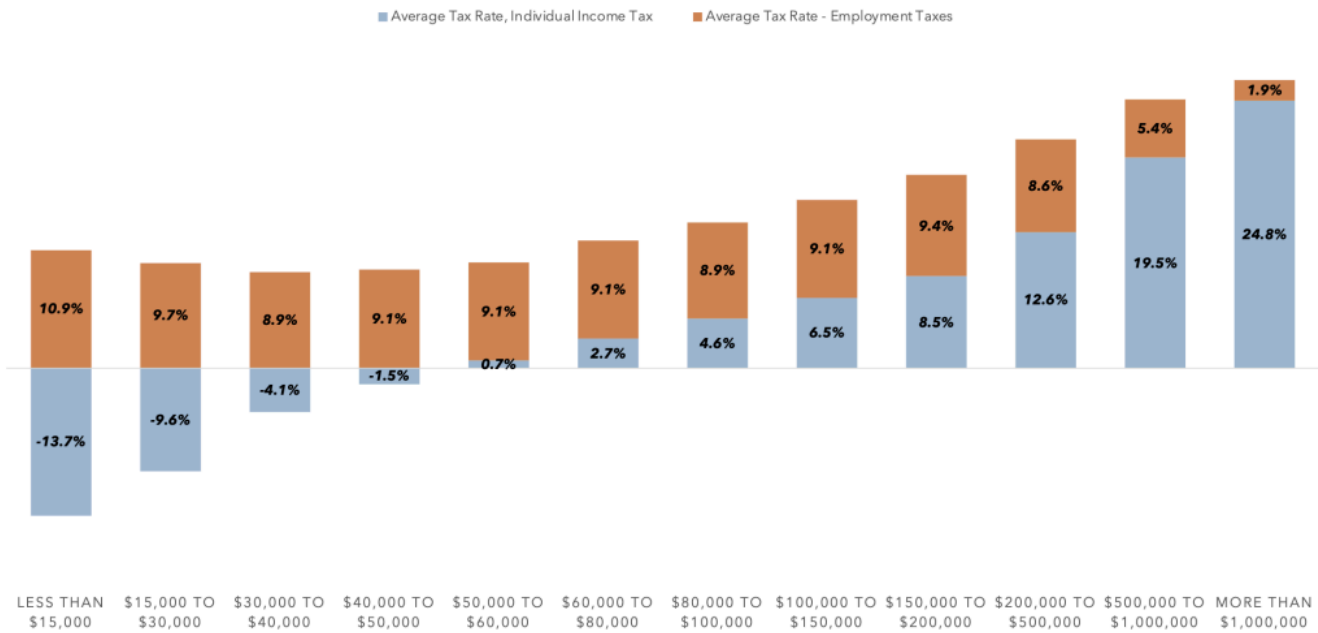
Statutory Tax Rate	For Single Filers	For Married, Joint Returns	For Heads of Households
10%	\$ - to \$ 11,000	\$ - to \$ 22,000	\$ - to \$ 15,700
12%	\$ 11,000 to \$ 44,725	\$ 22,000 to \$ 89,450	\$ 15,700 to \$ 59,850
22%	\$ 44,725 to \$ 95,375	\$ 89,450 to \$ 190,750	\$ 59,850 to \$ 95,350
24%	\$ 95,375 to \$ 182,100	\$ 190,750 to \$ 364,200	\$ 95,350 to \$ 182,100
32%	\$ 182,100 to \$ 231,250	\$ 364,200 to \$ 462,500	\$ 182,100 to \$ 231,250
35%	\$ 231,250 to \$ 578,125	\$ 462,500 to \$ 693,750	\$ 231,250 to \$ 578,100
37%	\$ 578,125 to or more	\$ 693,750 to or more	\$ 578,100 to or more

When an individual uses exemptions, deductions, and credits, their *effective tax rate* (ETR, i.e., tax liability divided by their taxable income) is frequently lower than the marginal tax rate (i.e., the statutory tax rate imposed on the last dollar of income). For that reason, the debate on tax policy is focused on the effective tax rate, not the marginal tax rate.

Social insurance receipts are taxes levied on individuals' wages. Employers and employees contribute an equal amount in Old-Age, Survivors, and Disability Insurance (OASDI) tax equal to 6.2 percent of gross income up to \$160,200 and an additional 1.45 percent in Hospital Insurance (HI), proceeds of which are used to fund the federal Medicare program. That is why they are referred to as *payroll taxes* or *withholding taxes*. In FY 2022, payroll taxes were \$1.48 trillion.

While the income tax is progressive, payroll taxes are regressive, with the highest average rate falling on Americans with the lowest income. For example, the estimated payroll tax burden for individuals making less than \$50,000 is between 9.1 and 10.9 percent, while the average payroll tax burden for individuals making more than \$500,000 was 5.4 percent – 1.9 percent for those making \$1 million or more.

Average or Effective Income and Payroll Tax Rates by Income Group



Source: Joint Committee on Taxation "Overview of the Federal Tax System as in Effect for 2023" (Table A-6)

There has been a lot of debate surrounding the 47 percent of taxpayers who do not pay federal income

taxes. That is correct – 47 percent of taxpayers don't pay federal income taxes. But that is by design! The income tax rates are low for low-income households. Coupled with deductions, exemptions, and tax credits (e.g., the child tax credit and earned income tax credit) –47 percent of taxpayers do not pay federal income taxes. They do, however, pay payroll taxes, state income taxes, sales taxes, property taxes, and taxes on gasoline, alcohol, and tobacco. Adjusting for state and local taxes, the U.S. tax system as a whole is, in fact, regressive.

What is frequently overlooked in the debate about the 47 percent is their share of income. The Joint Committee on Taxation estimates the 47 percent that did not pay federal income taxes earned 13 percent of total income. Sixty-six percent of total income is earned by the top 25 percent of tax filers (i.e., those reporting an annual income greater than \$100,000).¹ And while the effective (or average) income tax rates are higher for these filers, the economic value of their tax preferences – the value of their deductions, exclusions, exemptions, and preferential tax rates – far exceed direct government spending (e.g., Medicare, Medicaid, and Social Security) for those that do not pay federal income tax. Wealth inequality is even greater. The top 10 percent of households – those with at least \$1.2 million in net worth – own in aggregate 77 percent of the wealth in America, whereas the bottom half of families (approximately 63 million families reporting a net worth of \$97,000 or less) own in aggregate one percent of the wealth (Source: Ana Kent, Lowell Ricketts, and Ray Boshara “*What Wealth Inequality in America Looks Like: Key Facts & Figures*” Federal Reserve Bank of St. Louis).

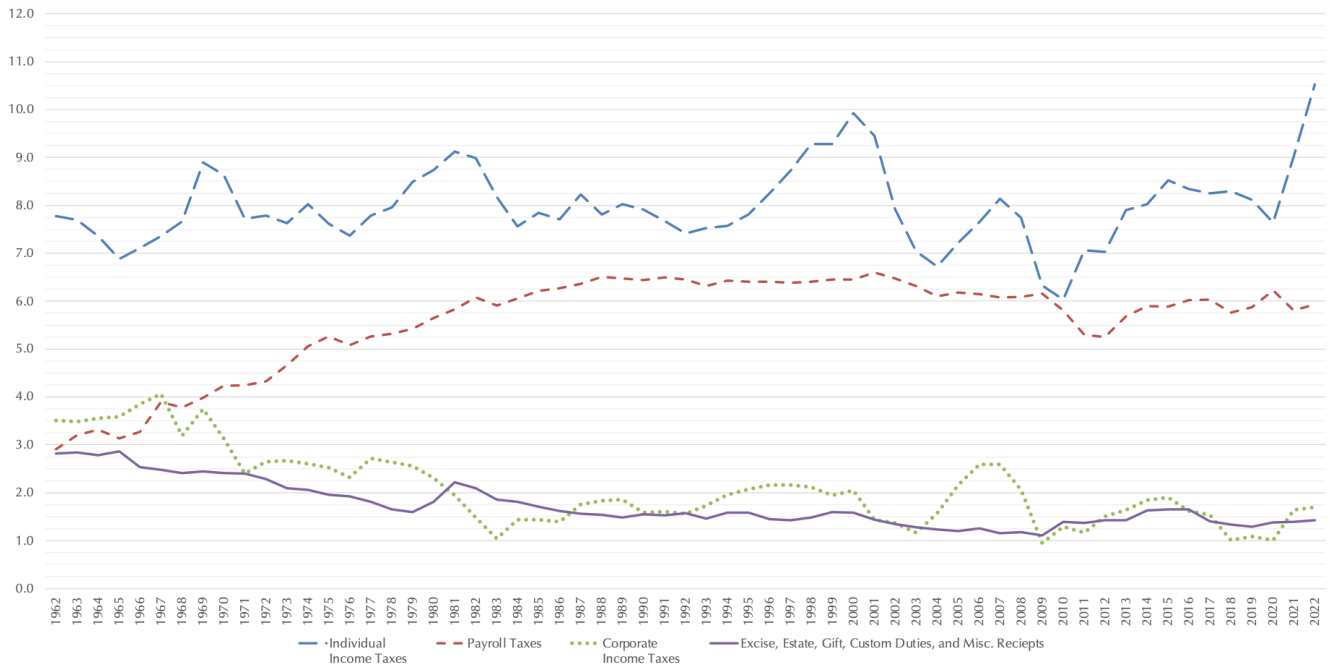
Suzanne Mettler, author of *The Government-Citizen Disconnect*, notes that the assumption that the welfare state serves low-income households is, in fact, false. **We are all beneficiaries!** What differentiates the 47 percent from everyone else is the visibility of government programs, services, and policies. Low-income households rely on government programs that make the government's role most apparent. The high-income households benefit from tax preferences that obscure the government's role and, as such, are not viewed as spending because appropriations are not made, and benefits checks are not sent.

The remaining 16 percent of federal revenue (\$781 billion) was from a variety of sources, including the corporate income tax (taxes on business income rather than individual income), excise taxes (taxes on the purchase of specific goods like gasoline, cigarettes, and airline tickets), and estate taxes (a tax imposed when a family's wealth is transferred from one generation to the next).

As shown in the figure below, revenues from corporate income tax, excise taxes, and estate taxes have either remained constant or declined as a share of GDP. In fact, growth in federal government revenues is primarily from the personal income tax, and much of that growth is driven by economic expansion as the top marginal income tax rates have declined from 91 percent on income in excess of \$200,000 in 1962 (or \$400,000 filing jointly) to 37 percent in 2020.² **The federal income tax is less progressive today than it was in 1962** when the government had 20 income tax brackets.

1. Wealth inequality is even greater. The top 10 percent of households – those with at least \$1.2 million in net worth – own in aggregate 77 percent of wealth in America, whereas the bottom half of families (approximately 63 million families reporting a net worth of \$97,000 or less) own in aggregate one percent of wealth (Source: Ana Kent, Lowell Ricketts, and Ray Boshara “*What Wealth Inequality in America Looks Like: Key Facts & Figures*” Federal Reserve Bank of St. Louis).
2. Adjusted for inflation, \$200,000 in 1962 is equivalent to \$1.7 million today.

Federal Government Revenues (% of GDP)

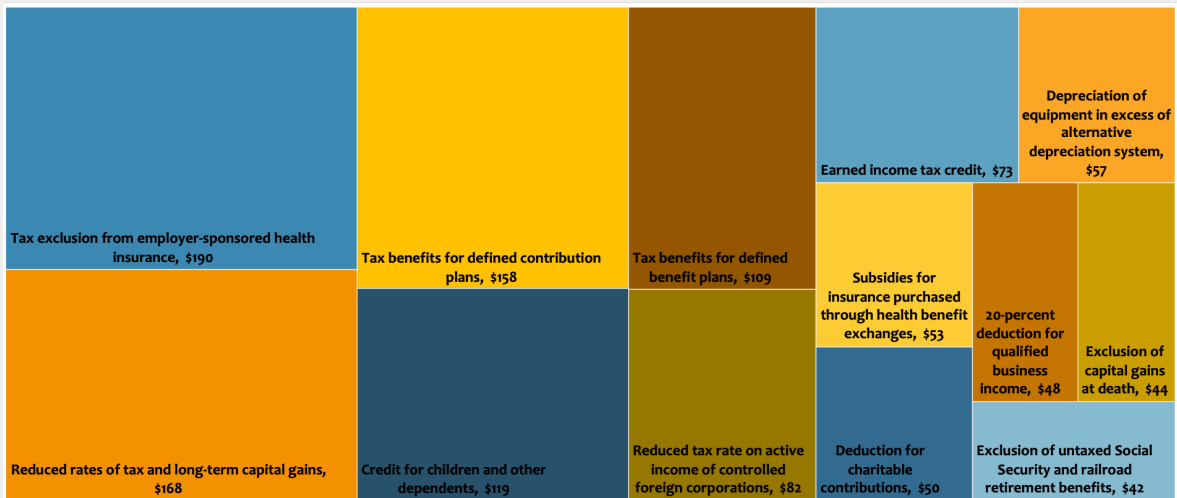


Source: Congressional Budget Office (2023) "An Update to the Budget Outlook 2023 to 2033"

TAX PREFERENCES: SPENDING BY ANOTHER NAME

Tax preferences – sometimes called tax expenditures – are provisions in tax law that allow preferential treatment of certain taxpayers. They include exclusions, exemptions, deductions, preferential tax rates, credits, deferrals, and anything else to reduce an individual's or a corporation's tax liability.

Exclusions, exemptions, and deductions reduce the amount of income subject to tax. Employer contributions to pension plans and employer-sponsored health care plans are excluded from the federal and state income tax. **Itemized deductions** are a special category of deductions, valuable only to taxpayers whose itemized deductions exceed the standard deduction. Itemized deductions are most valuable to high-income earners whose annual mortgage interest cost, state and local tax (SALT) deduction, and charitable contributions exceed the standard deduction. High-income earners are also more likely to invest in municipal bonds. Interest income from municipal debt is exempt from federal taxes. **Credits** reduce tax liability dollar for dollar by the amount of credit. Examples include the earned income tax credit (EITC) and child tax credit. **Preferential tax rates** benefit taxpayers who receive certain income. Income earned from capital gains and dividends, for example, are taxed at preferential rates that are significantly lower than the income tax rates. **Deferrals** allow taxpayers to delay payments without penalty. The federal government defers tax payments on income earned in qualified retirement plans. Payments are only required when beneficiaries withdraw assets from their retirement plans.



Source: Joint Committee on Taxation *Estimates of Largest Federal Tax Expenditures* (\$Billions, FY 2021)

Tax expenditures are, in effect, a form of spending. **They are also costly.** For comparison, the cost of all federal income tax expenditures is higher than Social Security and the combined cost of Medicare and Medicaid. They also exceed the combined cost of defense and non-defense discretionary spending.

Additionally, exclusions, exemptions, deductions, preferential tax rates, credits, and deferrals increase as household income rises. Put differently, **these subsidies benefit individuals that do not need them, further exacerbating racial disparities in income and wealth.** The child tax credit (\$119 billion) and earned income tax credit (\$73 billion) are exceptions.

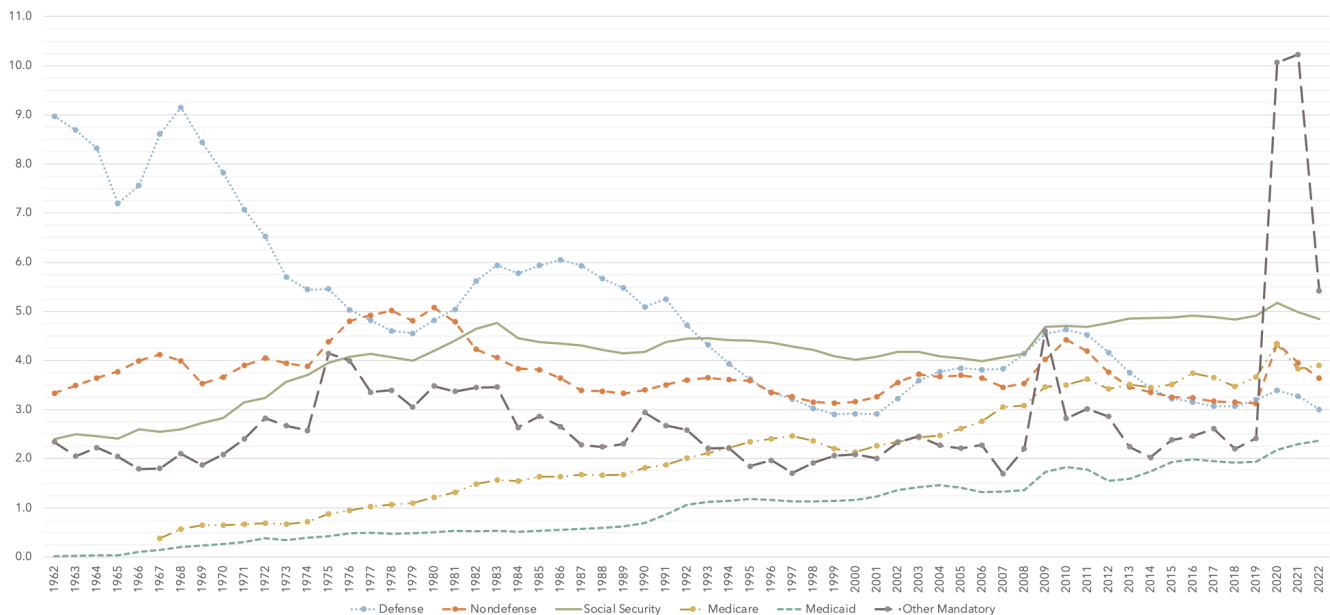
The 2017 Tax Cuts and Jobs Act did not advance racial equity in the federal tax code. In fact, core provisions tilt heavily towards households at the top of the income distribution. Analysis shows the highest-income (predominately white) households receive 23.7 percent of the TCJA tax cuts, far more than the 13.8 percent of tax cuts that go to the bottom 60 percent of households (of all races).

Sources: Center for Budget and Policy Priorities (2019) "Policy Basics: Federal Tax Expenditures" and Chye-Ching Huang and Roderick Taylor (2019) "How the Federal Tax Code Can Better Advance Racial Equity: 2017 Tax Law Took Step Backward" Center for Budget and Policy Priorities.

We often divide federal government spending into two categories: *discretionary* and *non-discretionary* spending, the latter of which is sometimes referred to as *mandatory* spending. Non-discretionary spending is controlled by law. Social Security is a good example. A person becomes eligible for “full” Social Security benefits once they are over the age of 65 and have paid payroll taxes for almost four years. Once they become eligible, their benefit is determined by a formula linked to the total wages earned during their last 35 years of employment. That formula is written into the law that created Social Security. Once a person becomes eligible, they are “entitled” to the benefits determined by that formula. Other programs like Medicare, food stamps, Supplemental Security Income, and many others follow a formula-based structure. If Congress and the President want to change how much is spent on these programs, they must change the relevant laws.

Discretionary spending includes appropriations for national defense and federal government agencies. This is spending that Congress and the President can adjust in the annual budget. In fact, the vast majority of federal spending is driven by laws, rules, and priorities that originate outside the budget. Data shows that non-discretionary spending is more than 65 percent of all federal spending. Add to those monies spent on interest on the national debt (roughly 7-8 percent), and we see that nearly three-quarters of federal spending is “locked in.” So, when Congress debates its annual budget, they are, in effect, debating on about 10 to 25 percent of what it will eventually spend.

Federal Government Outlays (% of GDP)

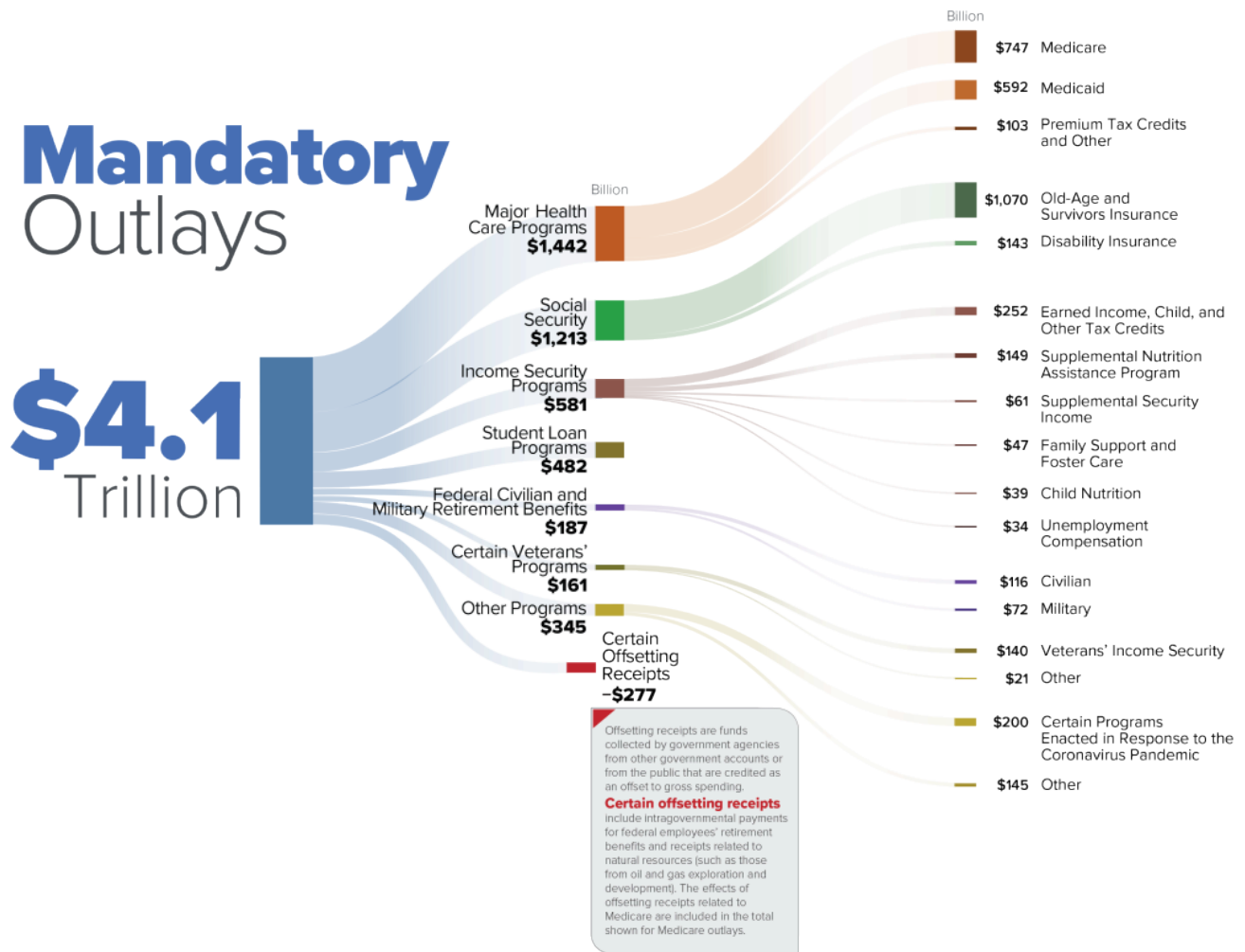


Source: Congressional Budget Office (2023) “An Update to the Budget Outlook 2023 to 2033”

In 2022, federal spending on mandatory programs was \$4.1 trillion. That included \$1.2 trillion in social security benefits, \$1.4 trillion in healthcare spending (primarily Medicare and Medicaid), \$581 billion in income security programs (unemployment compensation, earned income tax credits, supplemental nutrition assistance programs, etc.), and \$348 billion in federal civilian and military retirement benefits and other veterans’ programs.

The federal government spent \$1.4 trillion on healthcare, including Medicare and Medicaid. Federal spending in these two programs represents 37 cents of every dollar spent on health care in the

U.S. – more than private insurance (33 percent), out-of-pocket expenses (10 percent), or any other government program (20 percent).



Source: Congressional Budget Office (2023) "Mandatory Spending in Fiscal Year 2022"

Medicare is the federal government's health insurance program for the elderly. The program does not employ physicians or other healthcare providers. It is, in effect, a health insurance company funded by the federal government. Established in 1965, Medicare has three main components. "Part A" pays for hospital stays, surgery, and other medical procedures that require admission to a hospital. "Part B" covers supplementary medical services like physician visits and procedures that do not require hospital admission. "Part D" pays for prescription drugs. Part A is funded through payroll taxes and through premiums paid by individual beneficiaries, and Parts B and D are funded mostly through payroll taxes. Since 1966, Medicare enrollment has increased from 19 million to almost 60 million individuals.

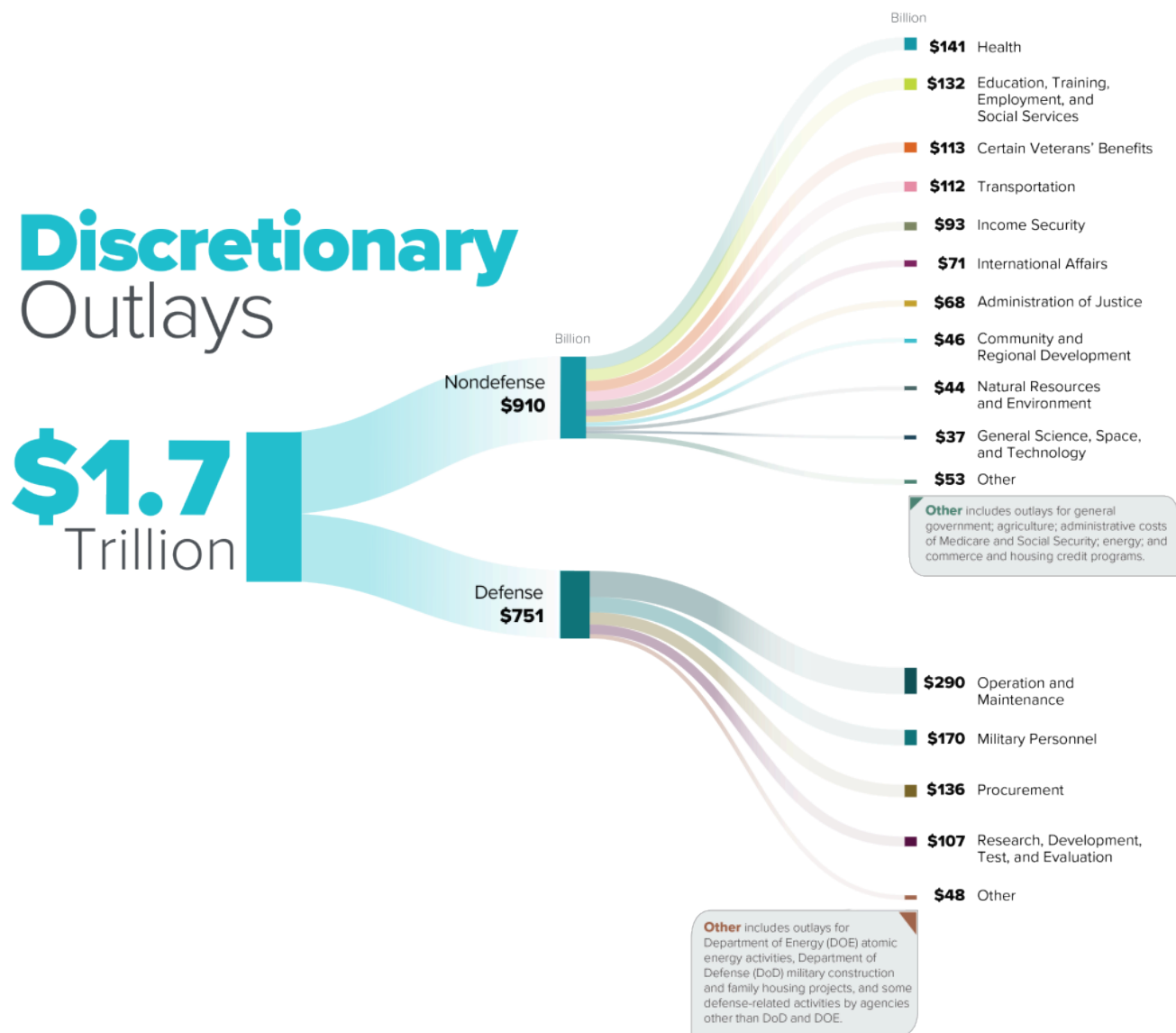
Created in 1935, Social Security is a federal income assistance program for retirees. In 2022, 66 million Americans – including 51 million retired workers, 9 million disabled workers, and 6 million

survivors of deceased workers – received \$1.07 trillion in benefits. Average benefits per month were \$1,755 for retired workers, \$1,486 for disabled workers, and \$1,451 for survivors – all of which are nominally above the poverty rate.

Medicare and Social Security are intergenerational transfer systems. Today’s workers help pay for current retirees’ and beneficiaries’ benefits, not their own future benefits. Put differently, there is no account set aside with your name or contributions on it.

Without legislative action, the Social Security trust funds are projected to be exhausted in 2034. At that point, the Social Security Administration (SSA) will no longer be able to pay beneficiaries’ benefits in full, as the SSA would be limited to the amounts payable from dedicated funding sources, per current law.

Income security programs are cash and cash-like assistance programs outside of Social Security. Most of these programs help individuals pay for specific, basic necessities. Included in income security programs are the Earned Income Tax Credit, supplemental nutrition assistance program (or SNAP), supplemental security income, COVID-19 federal stimulus checks, and unemployment compensation, to name a few. Expanded benefits during and following the COVID-19 pandemic exceeded 10 percent of GDP in 2020 and 2021.



Source: Congressional Budget Office (2023) "Discretionary Spending in Fiscal Year 2022"

Discretionary spending was \$1.7 trillion in FY 2022, including \$751 billion in defense spending and \$910 in non-defense spending.

National defense includes pay and benefits for all members of the U.S. Army, Navy (including Marines), Air Force, and civilian support services. Defense budgets include capital outlays – spending on items with long useful lives – for military bases, planes, tanks, and other military hardware. National defense spending remains a top priority of the federal government. In FY 2022, defense spending was 13 percent of all federal spending (keep in mind that the \$751 billion in discretionary defense spending excludes \$113 billion in veterans benefit services that are budgeted as non-defense discretionary spending and \$348 billion in veterans' health and retirement benefits budgeted as mandatory spending).

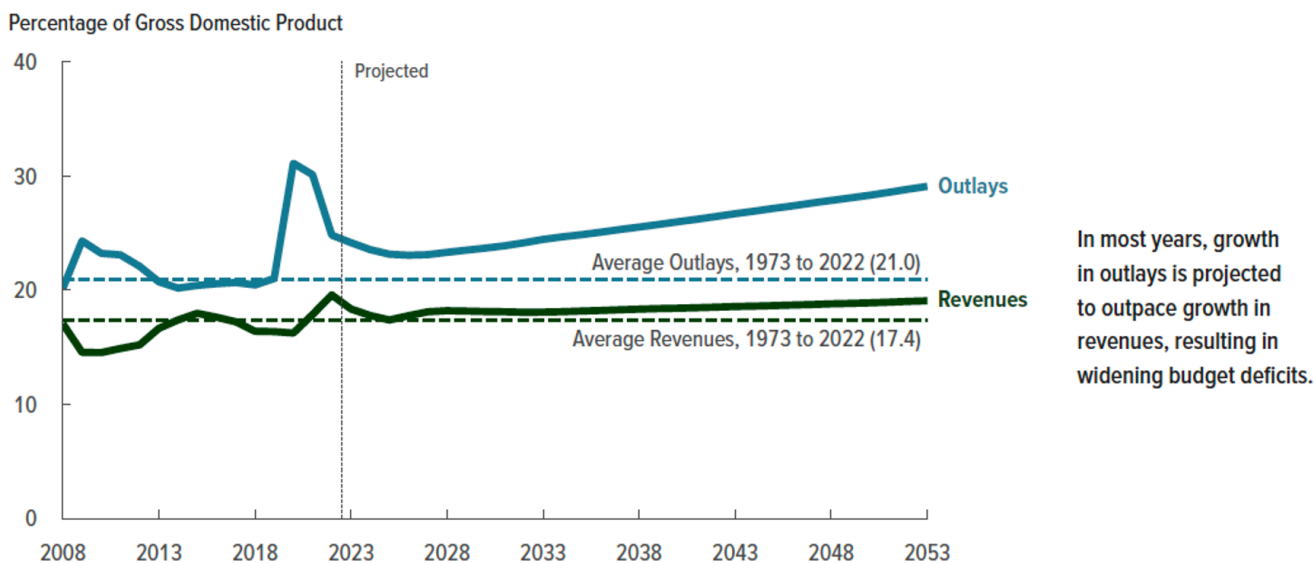
The U.S. defense budget exceeds those of China, Russia, Saudi Arabia, India, France, the U.K., and Japan – combined! There is considerable debate on whether national defense is, in fact, discretionary

spending. That said, the real question is whether, in the absence of any other military superpower, we might be spending more than would be appropriate.

All other spending or *non-defense discretionary* (NDD) includes appropriations for healthcare and research (including funding for public health and population health agencies like the National Institutes of Health (NIH) and the Centers for Disease Control (CDC), and for health-focused regulatory agencies like the Food and Drug Administration (FDA)), transportation and economic development, education, income security (e.g., special supplemental nutrition program for Women, Infants, and Children (WIC), the low-income home energy assistance program, and child care and development block grants), law enforcement, the environment, and international affairs.

NDD spending was 3.6 percent of GDP. Except in periods of crisis (e.g., the Great Recession and the COVID-19 pandemic), NDD spending has been declining as a share of the economy. Congress, for example, has approved more than \$5.3 trillion in federal stimulus spending since the start of the COVID-19 pandemic.

This discussion raises another absolutely essential point: **The federal government has a substantial structural deficit.** A *structural deficit* is when a government’s long-term spending exceeds its revenues. In 2022, the federal government had a \$1.4 trillion budget deficit (or 5.5 percent of GDP). To support economic recovery, the federal government approved several pieces of legislation that resulted in a \$3.1 trillion (or 14.9 percent of GDP) deficit in 2021 and a \$2.8 trillion (or 12.4 percent of GDP) in 2020. Assuming no significant changes in spending or revenue policies, the annual budget deficit is projected to grow to 10 percent of GDP.



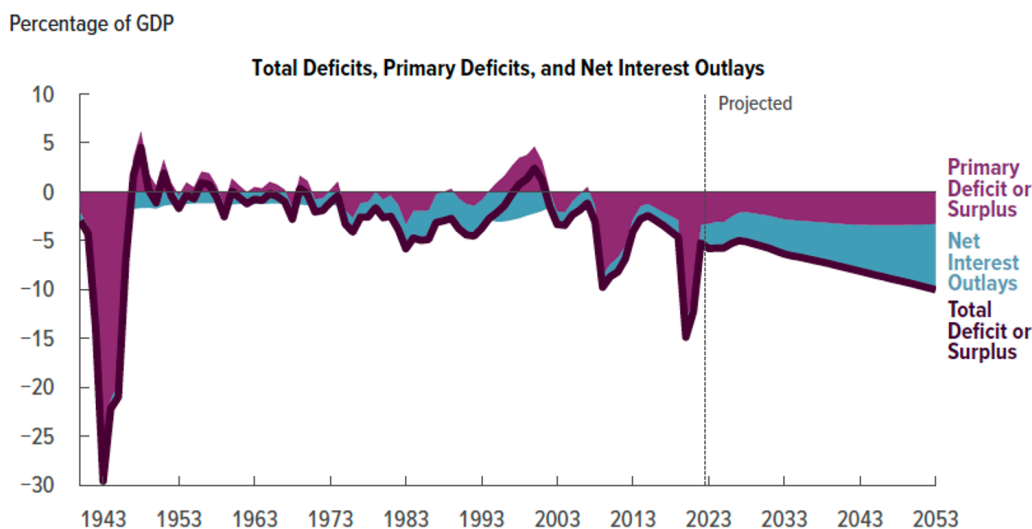
Source: Congressional Budget Office (2023) “The 2023 Long-Term Budget Outlook”

Why is the deficit expected to grow so quickly? In part because mandatory spending is going to continue to grow. More and more of the “Baby Boomer” population will become eligible for Medicare,

Social Security, and other programs. As the eligible population grows, so too will spending. The cost of health care services has increased three to four times faster than all other costs across the economy. That’s why health-related non-discretionary spending is the proverbial “double whammy” – the number of people who need those services will increase, and so will the rate of spending per person to deliver those services. At the same time, most economists are projecting slower economic growth for the next several decades. Given the federal government’s current revenue policies, that will mean slower revenue growth over time. Those two main factors – growth in non-discretionary spending and slower revenue growth – will lead to much larger deficits over time.

The federal government’s structural deficit is the single most important trend in public budgeting and finance today. Without major changes in federal government policy, especially in areas like Medicare and Social Security, the federal government will have no choice but to run enormous deficits and cut non-discretionary spending. Those cuts will mean less money for many of the key programs you probably care about basic scientific research, student loans, highways, transit systems, national parks, and every other discretionary program. In fact, some cynics have said that in the future, “the federal government will be an army with a health care system.”

State and local governments will be forced to take on many of the services the federal government used to provide in areas like affordable housing, environmental protection, and international trade promotion. At the same time, some optimists say this is a welcome change. Without the rigidity and uniformity of the federal government, local communities will have the latitude and flexibility to experiment with new approaches to social problems. What’s not debatable is that absent major changes in policy, especially for non-discretionary spending, federal government spending will look quite different in the not-too-distant future.

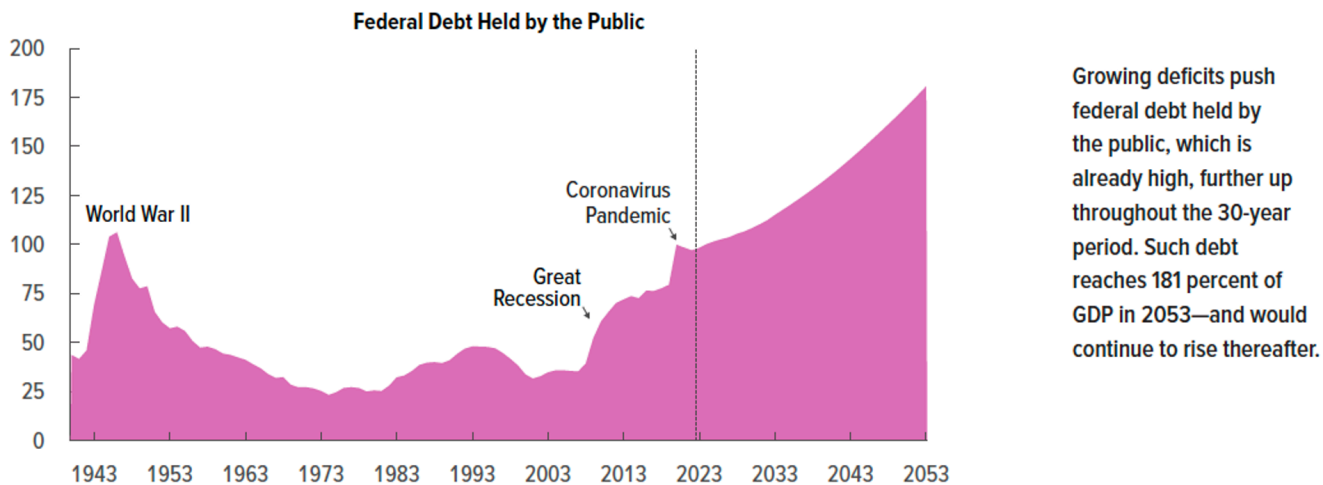


In CBO’s projections, primary deficits exceed their historical 50-year average of 1.5 percent of GDP throughout the projection period. In 2053, the primary deficit equals 3.3 percent of GDP. Driven up by large and sustained primary deficits and by rising interest rates, net interest outlays reach 6.7 percent of GDP in 2053.

Source: Congressional Budget Office (2023) “The 2023 Long-Term Budget Outlook”

You’re probably wondering how the federal government will finance those deficits. If the government does not collect enough revenue to cover its spending needs, it borrows. The figure below shows

national debt as a percent of GDP from 1943, including projections for the three decades. At the end of FY 2019, federal government debt was around 79 percent of GDP and increased to 97 percent of GDP at the end of 2022. The national debt burden is expected to rise to 115 percent of GDP in 2033 and 181 percent in 2053.



Source: Congressional Budget Office (2023) "The 2023 Long-Term Budget Outlook"

WHAT MOVES INTEREST RATES?

Interest rates are one of the most important numbers in public budgeting and finance. Interest is what it costs to use someone else's money. Banks and other financial institutions lend consumers and governments money at "market interest rates" like the annual percentage rate (APR). Small changes in interest rates can mean big differences in the cost of delivering public projects. That's why it behooves public managers to know what drives interest rates.

Interest rates fluctuate for a variety of macroeconomic reasons. If inflation is on the rise, then businesses will be less willing to spend money on new buildings, equipment, and other capital investments. If the demand for capital investments is down, then so is the demand for borrowed money to finance those investments. In those market conditions, banks and other financial institutions will lower their interest rates on loans to entice businesses to make those investments. The opposite is also true. Businesses will seek to invest during periods of low inflation, which drives up demand for borrowed money and drives interest rates up. Government borrowing and capital investment can also drive demand for borrowed money. Macroeconomists have complex models that explain and predict these interrelationships between consumer spending, investments, and government spending.

The U.S. Federal Reserve Bank – "The Fed" – is also a crucial and closely-watched player. The Fed is the Central Bank. It lends money to banks and holds deposits from banks throughout the U.S. Its mission is to fight inflation and keep unemployment to a minimum. In finance circles, this is called the Dual Mandate.

The Fed has many tools to achieve that mission, and most of those tools involve interest rates. It can raise or lower the Federal Funds Rate or the interest rates at which banks lend money to each other. It can demand that banks keep more money on deposit at the Fed. Increases in either will reduce the amount of money banks have available to lend, which drives up interest rates. Its most powerful tool is called open market operations (OMO). If the Fed wishes to lower interest rates, it buys short-term Treasury bonds and other financial securities from investors. This increases the money available for lending and reduces interest rates. When it wishes to raise rates, it sells securities to banks. When banks buy those securities, they have less money available to

lend, and that increases interest rates.

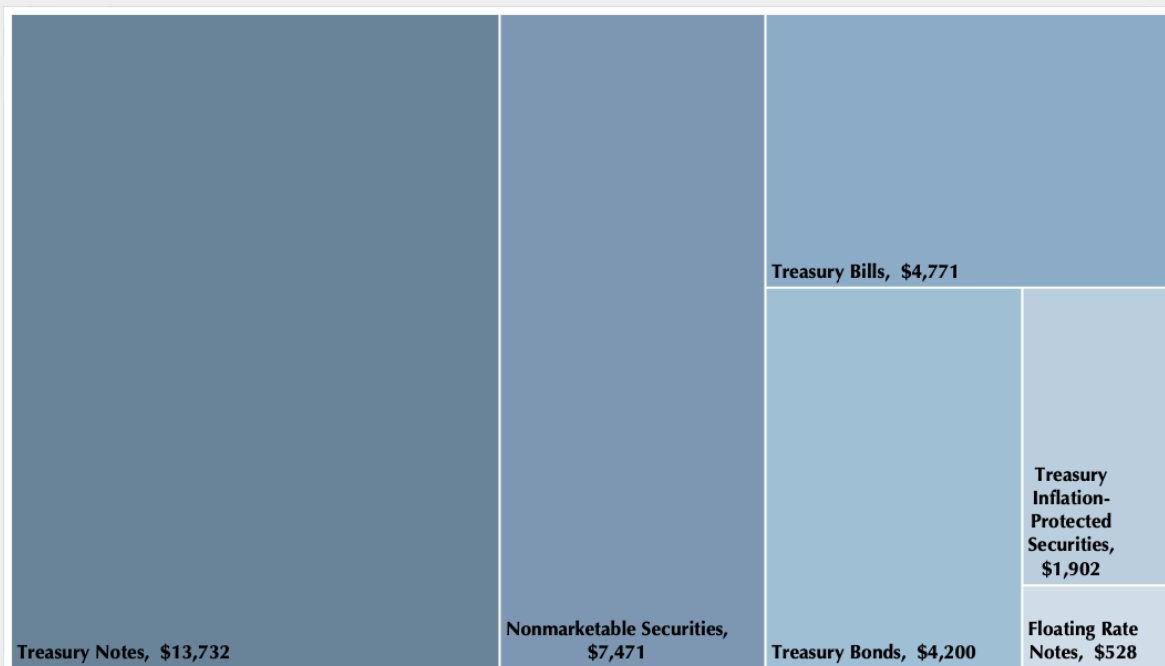
This rapid growth in debt is concerning for many reasons. First, federal government borrowing “crowds out” borrowing by small businesses, homeowners, state and local governments, and others who need to borrow to invest in their own projects. Since there are only so many investors with money to invest, if the federal government takes a larger share of that money, there’s less for everyone else. Many economists and finance experts have also warned that if the federal government’s debt grows too high, then investors might be less willing to loan it money in the future. If investors are less willing to loan the government money, the government must offer higher interest rates to increase investors’ return on investment. As the federal government’s interest rates rise, interest rates rise for everyone else. Occasional increases in interest rates are not necessarily bad, but prolonged high-interest rates mean less investment by people and businesses, resulting in lower productivity and slower economic growth.

WHAT IS THE DEBT LIMIT?

Created by Congress in 1917, the debt limit, or debt ceiling, sets the maximum amount of debt the U.S. government can incur.³ The amount is set by law, and once the limit is reached, the government must either (a) raise the debt limit, (b) suspend the debt limit from taking effect, (c) violate the debt limit or (d) default on its obligations to pay its bills. Congress has raised or suspended the debt limit more than 100 times since 1940. Raising or suspending the debt limit does not authorize new spending. It simply allows for the government to pay for obligations that Congresses and presidents have made in the past.

With political polarization deepening over the last decade, votes to raise the debt ceiling have remained contentious, with congressional budget hawks increasingly demanding spending cuts in return for their support. On January 19, 2023, the U.S. Treasury reported it had reached the \$31.4 trillion debt limit and begun using “extraordinary measures” to meet the government obligations without violating the limit. Following negotiations, Congress voted to suspend the nation’s debt ceiling through January 2025 in exchange for limits on the growth in non-defense spending. Suspending the debt ceiling gives Treasury the latitude to borrow as much money as it needs to pay the nation’s bills. It also kicks the potential fight for raising the debt ceiling past the next presidential elections.

Treasury Securities Outstanding (July 2023, \$Billions)⁴



Debate on the debt ceiling is not a costless effort. With every debt ceiling debacle, confidence in the U.S. government, the world’s reserve currency, is eroded. The last time the U.S. was pushed to the brink of a default resulted in a rating downgrade by S&P, one of the major rating agencies (from AAA to AA+). On August 1, 2023, Fitch Ratings downgraded the U.S. long-term rating to AA+ from AAA, citing “growing general government debt burden and the steady deterioration in the standards of governance.”

3. The first debt limit was established in 1917 to make it easier to finance mobilization efforts in World War I. Before that, Congress had to authorize each bond issue.
4. The federal government borrows money by issuing treasury bills, notes, bonds, nonmarketable securities, and other securities. Treasury bills have a maturity of three months up to 12 months. Treasury notes have maturities of two years to ten years. Treasury bonds mature in 10 years up to 30 years. Nonmarketable securities include securities issued to state and local governments and federal trusts (e.g., Social Security). Floating rate notes are short-term investments (mature in two years or less) that have an interest rate that may change (or float) over time, while Treasury Inflation-Protected Securities (or TIPS) are indexed to inflation to protect investors from a decline in the purchasing power of their investment.

Uncertainty will likely raise interest rates. Higher interest rates make solving the long-term fiscal problem harder, with ramifications for practically every sector of the economy. While the economic consequences of an intentional default, an unprecedented event in American history, are unknown, there is no doubt they would be catastrophic.

STATE GOVERNMENTS

There's an old adage that state governments are in charge of “medication, education, and incarceration.” That saying is both pithy and true. State government expenditures in 2021 were \$2.3 trillion, and most of it was spent on primary and secondary education, public universities and community colleges, healthcare, public assistance, state highways, corrections, and public safety.

States vary a lot in how much of those services they deliver and how they pay for those services. In some regions, the state is one of the largest employers. This is especially true in rural areas with state universities or prisons. In other regions, state governments have a limited presence.

States rely on a few key revenue sources. State-wide sales taxes are one-fifth of state government revenue and nearly 50 percent of state tax revenues. There are two basic types of sales taxes: a *general sales tax* that applies to all retail sales transactions and *special sales taxes* that apply only to sales of certain goods and services, such as gasoline, tobacco, alcohol, and gambling. Some states tax construction, personal trainers, catering, and other professional services, while many do not. Many special sales taxes are administered as excise taxes.

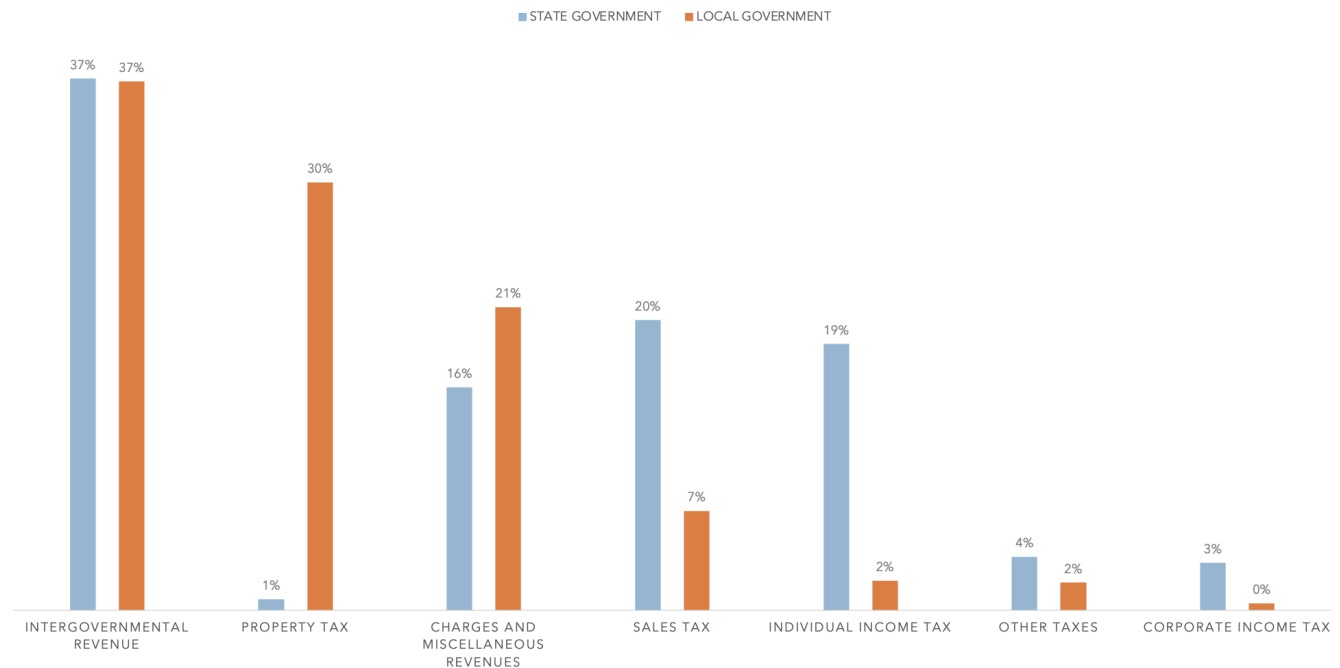
Five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) do not have state-wide sales tax. Although, Alaska does allow its local governments to collect local sales taxes. California has the highest state-level retail sales tax rate, at 7.25 percent, followed by Indiana, Mississippi, Rhode Island, and Tennessee at 7 percent (Tax Foundation, *State and Local Tax Rates 2023*). States that are heavily reliant on sales and excise taxes are more likely to have regressive tax systems.

Like with the income tax, sales tax revenues are derived from a tax rate applied to a taxable base. A state's sales tax base is all the retail sales of personal property that happen within its borders. The challenge is that it's not always clear what is included in that taxable base. For instance, in Illinois, candy that contains flour and does not require refrigeration (e.g., Twix) is exempt from the state's retail sales tax. In New York, an “unaltered bagel” is not subject to the 8.85 percent retail sales tax, whereas a sliced bagel is. When a company does business in multiple states, it must follow complex tax codes to determine the sales tax it owes in each state.

Online retailers like eBay and Amazon have long argued that they should not have to collect and remit sales taxes if they do not have nexus (or physical presence) in the state in which the purchaser resides. In 2018, the U.S. Supreme Court ruled in *South Dakota v. Wayfair* that businesses with more than 200 transactions or \$100,000 in-state sales – but without a physical presence in the state – must collect and remit sales taxes. Consumers are now required to remit sales taxes to the vendor or pay an equivalent amount known as a use tax directly to the state. Some states will go so far as to send residents an estimated use tax bill to residents if the vendor fails to collect and remit sales taxes.

In many states, the goods and services purchased by businesses for the purposes of producing a good or delivering a service are exempt from sales taxes. Doing so prevents tax-pyramiding. For these and other reasons, sales tax administration is quite complex.

State and Local Government Revenues by Source (2021)



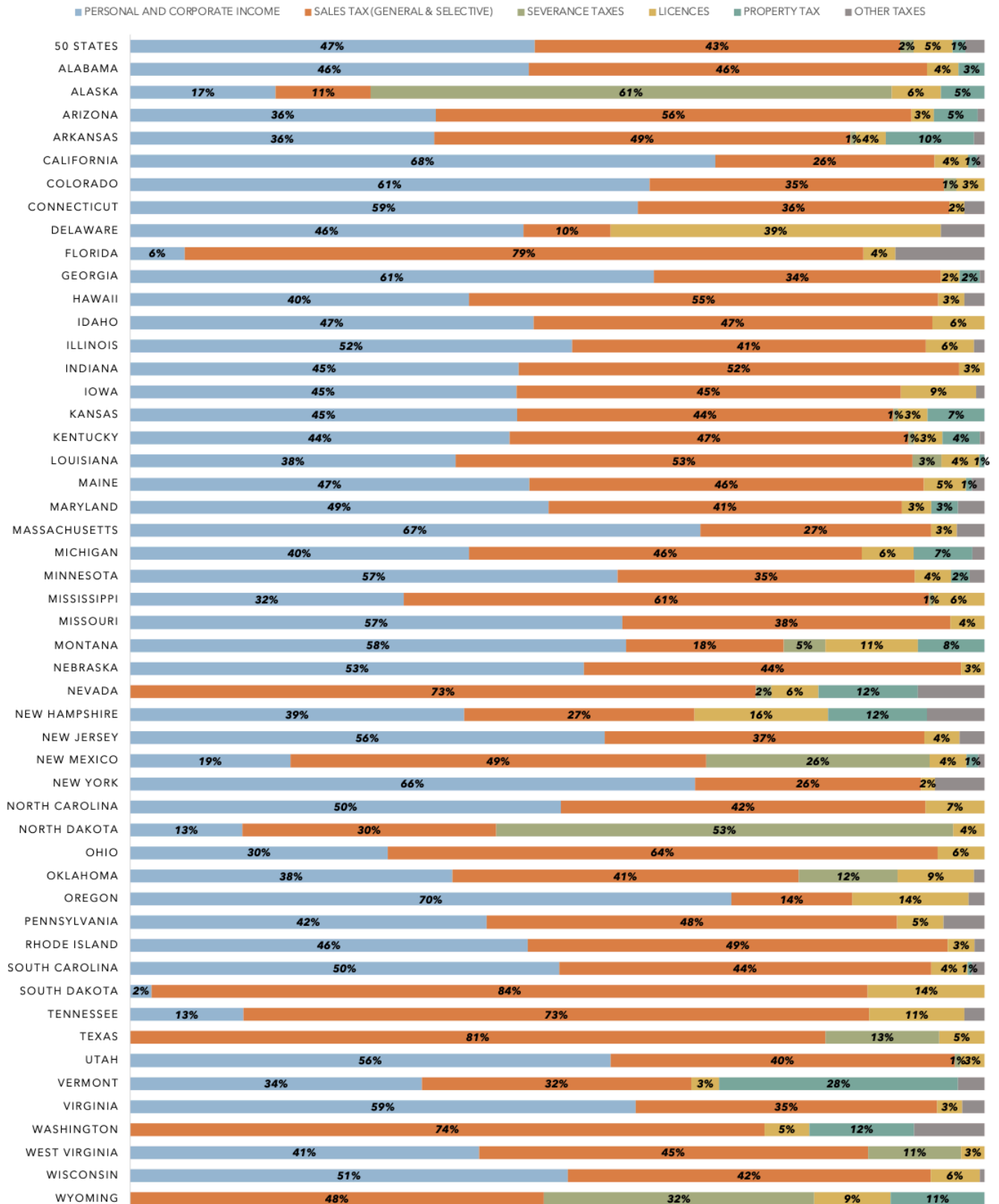
Source: 2021 State & Local Government Finance Census Data and author's estimates.

State-wide individual income taxes are one-fifths of state government revenue and one-third of state tax revenues. Seven states – Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming – do not have a state-wide individual income tax.

State income taxes are administered much like the federal income tax. In fact, most states apply the federal government's definition of taxable income to determine state taxable income. In New Hampshire and Tennessee, the individual income tax is limited to dividend and interest income only (Tax Foundation, State Individual Income Tax Rates, and Brackets 2020).

Thirty-two states have graduated-rate income taxes. A graduated-rate structure does not guarantee progressivity. Higher rates have to apply to high-income taxpayers while holding harmless low- and middle-income taxpayers. Tax credits (e.g., childcare credit, earned income tax credit), exemptions, and deductions specifically targeted toward low- and middle-income taxpayers can enhance the progressivity of an income tax.

State Government Tax Revenues (by Source, 2022)



Source: The Pew Charitable Trusts - How States Raise Their Tax Dollars (FY 2022) using data published by the Census Bureau

WHAT IS A “FAIR” TAX?

Governments tax many different types of activity with many different types of revenue instruments (taxes, fees, charges, etc.). Each instrument is fair in some ways but less fair in others. In public finance, we evaluate taxes across several dimensions:

- **Efficiency.** Basic economics tells us that if a good or service is taxed, then consumers will purchase or produce less of it. *An efficient tax minimizes these market distortions.* For instance, most tax experts agree that the corporate income tax is one of the least efficient. Most large corporations are willing and able to move to the state or country where they face the lowest possible corporate income tax burden. When they move, they take jobs, capital investments, and tax revenue with them. The property tax, by contrast, is one of the most efficient taxes. The quantity of land available for purchase is fixed, so taxing it cannot distort supply the same way that taxing income might discourage work, or that taxing investment might encourage near-term consumption.
- **Vertical Equity.** Vertical equity means the amount of tax someone pays increases with their ability to pay. Most income tax systems impose higher tax rates on individuals and businesses with higher incomes. This is meant to ensure that taxpayers who have a greater ability to pay will contribute a higher share of their income through taxes.

A tax with a high degree of vertical equity, like the income tax, is known as a progressive tax. A regressive tax is a tax where those who have less ability to pay ultimately pay a higher share of their income in taxes. The retail sales tax is a regressive tax. Those who are least able to pay often pay comparatively more of it as a share of income. For instance, a family with high annual income will pay the same amount in sales tax for school supplies as a low-income family. The **effective tax rate** (i.e., sales tax liability as a percent of income) will be higher for the low-income household when compared to the high-income household.

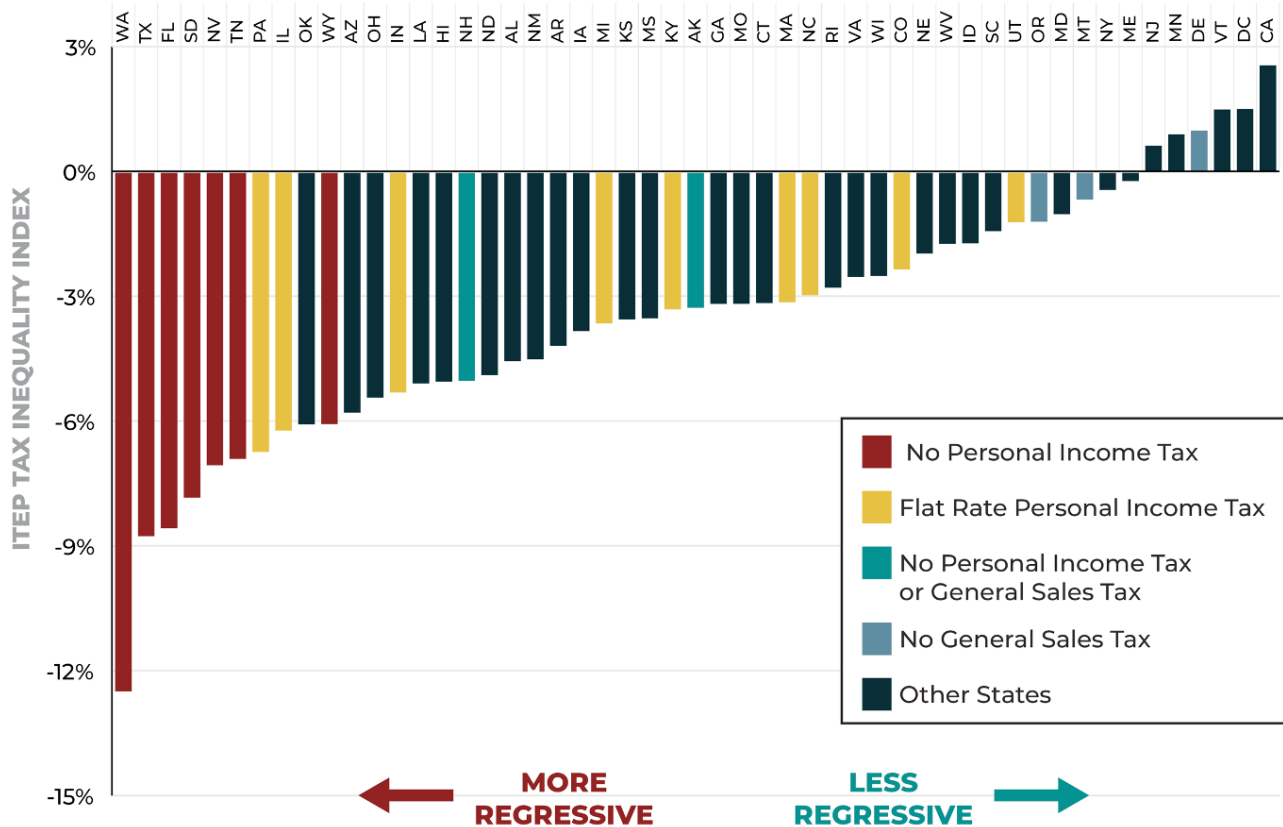
- **Horizontal Equity.** Sometimes called “tax neutrality,” horizontal equity means that people with similar abilities to pay contribute a similar amount of taxes. The property tax is a good example of a tax that promotes horizontal equity. With a properly administered property tax system, homeowners or business owners with similar properties will pay similar amounts of property taxes. Income taxes are quite different. Because of tax preferences, it’s entirely possible for two people with the same income to pay very different amounts of income tax.
- **Elasticity.** An elastic tax responds quickly to changes in the broader economy. If the economy is growing and consumers are spending money, collections of elastic taxes increase and overall revenue grows. This is quite attractive to policymakers: with elastic taxes, they can see growth in tax collections without increasing the tax rate. Of course, the opposite is also true. If the economy is in recession, consumer spending decreases, and so do revenue collections. Sales taxes and income taxes are the most elastic revenues.
- **Stability.** A stable tax does not respond quickly to changes in the economy. Property taxes are among the most inelastic taxes. Property values do not fluctuate as much as prices of other goods, so property tax collections don’t increase or decrease nearly as fast as sales or income taxes. While the tax is stable, it does not grow as fast. Put differently, the property tax is stable but inelastic, whereas the income tax is elastic but unstable.
- **Administrative Costs.** Some taxes require a lot of time and resources to administer. Property taxes are a good example. Tax assessors go to great lengths to make certain the appraised value they assign to a home or business is as close as possible to its actual market value. To do this, they perform spatial analysis. That analysis demands time and expertise.

The chart below illustrates a basic fact about taxation: all taxes come with trade-offs. For instance, the property tax is stable and promotes horizontal equity, but it’s costly to administer and generally non-responsive to broader trends in the economy. The sales tax is cheap to administer and produces more revenue during good economic times but is regressive. To ensure vertical equity, the income tax has to impose higher taxes on individuals and businesses with higher incomes. Note that for many of these instruments, the evidence is mixed. That is, tax policy experts disagree on whether that characteristic is a strength or weakness for that particular revenue instrument.

	Property Tax	Sales Tax	Income Tax	Charges & Fees
Vertical Equity	+/-	-	+	-
Elasticity	-	+	+	+/-
Stability	+	-	-	+/-
Administrative Costs	-	+	+/-	+/-
Horizontal Equity	+	+	-	+
Efficiency	+	+/-	-	+/-
Strength	+	Weakness	-	Mixed
				+/-

In their 2018 “Who Pays” report, the Institute of Taxation and Economic Policy (ITEP) once again found that states that rely on sales and excise tax and less on graduated personal income taxes are more likely to tax their lowest-income residents at higher rates than the top one percent of taxpayers.

ITEP’s *Tax Inequality Index* measures the effects of each state’s tax system on income inequality by assessing its impact on the incomes of taxpayers at different income levels. The chart below shows that states without a personal income tax (Washington, Texas, Florida, South Dakota, Nevada, and Tennessee) and those with a flat personal income tax (e.g., Pennsylvania and Illinois) have regressive tax structures. States with graduated personal income taxes that hold harmless low- and middle-income taxpayers are less regressive or, in more positive terms – progressive. The distributional impact of the tax systems on income has clear implications for wealth inequality among racial groups. **Tax codes that are regressive not only worsen income inequality; they worsen the racial income and wealth divides.**



Source: <https://itep.org/whopays/> States with regressive tax structures have negative inequality index scores, meaning incomes are less equal in those states after state and local taxes than before. States with progressive tax structures have positive inequality index scores. In these states (California, Washington D.C., Vermont, Delaware, Minnesota, and New Jersey), incomes are more equal after collecting state and local taxes than before.

All state governments depend to some extent on **intergovernmental revenues** (IGRs). For state governments, IGRs are used to meet the federal government’s share of mandatory spending. Medicaid is the largest and most important for most states. The federal government also sends states money for transportation infrastructure, the Child Health Insurance Program (or S-CHIP), federal student loan assistance, and many other programs.

Federal IGR falls into roughly two categories: *categorical grants* that are restricted to specific purposes and *block grants* that are less restricted but must produce measurable outcomes or deliverables. Federal funds for highways and university research are good examples of categorical grants. The Community Development Block Grant program is a good example of a block grant.

Most state revenues are from the sales tax, income tax, and IGR. That said, states do depend on a variety of other tax revenues (e.g., taxes on oil, gas, coal, other minerals, timber, and fish, as well as death and gift taxes). Some states levy a property tax on transactions of certain personal property, like vehicles. States also generate revenue through fees, including tuition from public universities and colleges, highway tolls, charges to patients and private insurance companies at public hospitals, and licenses on everything from hunting to running a tavern to practicing medicine. Some states also tax private electricity and water utility operators.

State spending has grown substantially over the past few decades. In 1977, the average state’s per

capita spending was around \$2,800. In 2021, it was \$7,500. Revenues have grown on a similar trajectory. But note that growth was not uniform. Spending in states like Arizona, California, Colorado, and Washington grew far slower than the average. This is not a coincidence. These states have passed strict laws, broadly known as *tax and expenditure limitations*, that restrict how quickly their revenues and spending can grow. States without those limits, like Connecticut, Delaware, New York, and Massachusetts, have seen much faster growth in both revenues and spending. North Dakota, Wyoming, and New Mexico saw large jumps in revenues and spending in the past decade or so, due mostly to the growth of their respective shale oil industries (more commonly known as fracking).

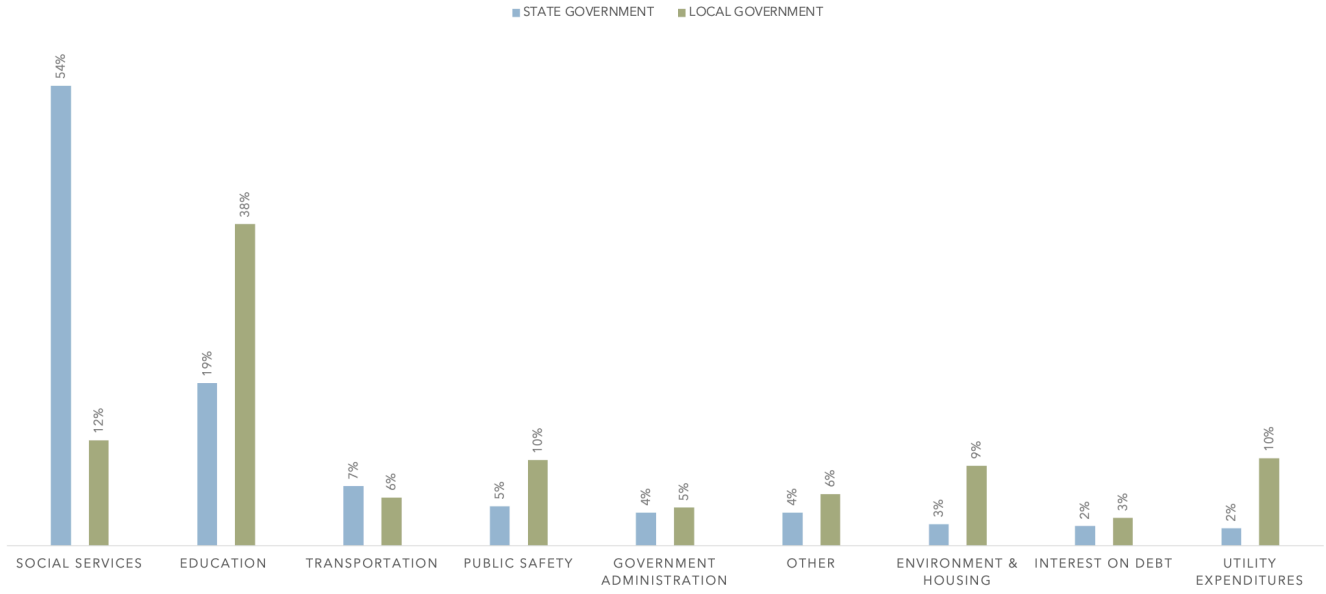
A third important trend is that state revenues roughly equal state spending. Virtually every state's constitution requires that its legislature and governor pass a balanced budget. As you'll see later, a "balanced budget" can mean rather different things in different places. But overall, states do not spend more money than they collect. This is in sharp contrast to the federal government. As you saw above, throughout the past several decades the federal government's spending has routinely exceeded its revenues. Unlike the federal government, states cannot borrow money to finance an operating budget deficit. In a number of states, restrictions on balanced budgets are enshrined in law.

Most of state spending is around health, education, transportation, and corrections. About one-half of state spending was in *social services* – which includes state spending on the Medicaid and mean-tested cash assistance programs (\$795 billion); state investment in public hospitals and community clinics; and healthcare programs like vaccinations, diabetes prevention, and outreach programs to prevent sexually transmitted diseases (\$177 billion).

Medicaid is the federal government's healthcare program for the poor. It is delivered in partnership with the states. Each state designs its own Medicaid program, and the federal government covers 50-70 percent of the spending related to that program.

Medicaid is *non-discretionary* spending for state governments. Medicaid is to the states what Medicare is to the federal government: a massive health insurance program that is expected to cover more people and become vastly more expensive over time. In most states, an individual qualifies for Medicaid once their income falls below a certain level. Medicaid is also the default health insurer for many vulnerable populations, including foster children, the permanently disabled, and the mentally ill. Older individuals who are poor or disabled often qualify for both Medicare and Medicaid. They are known as *dual-eligibles* – 18 percent of Medicare patients are eligible for Medicaid coverage as well. In fact, growth in Medicaid spending is the result of spending on long-term care and nursing homes for the elderly.

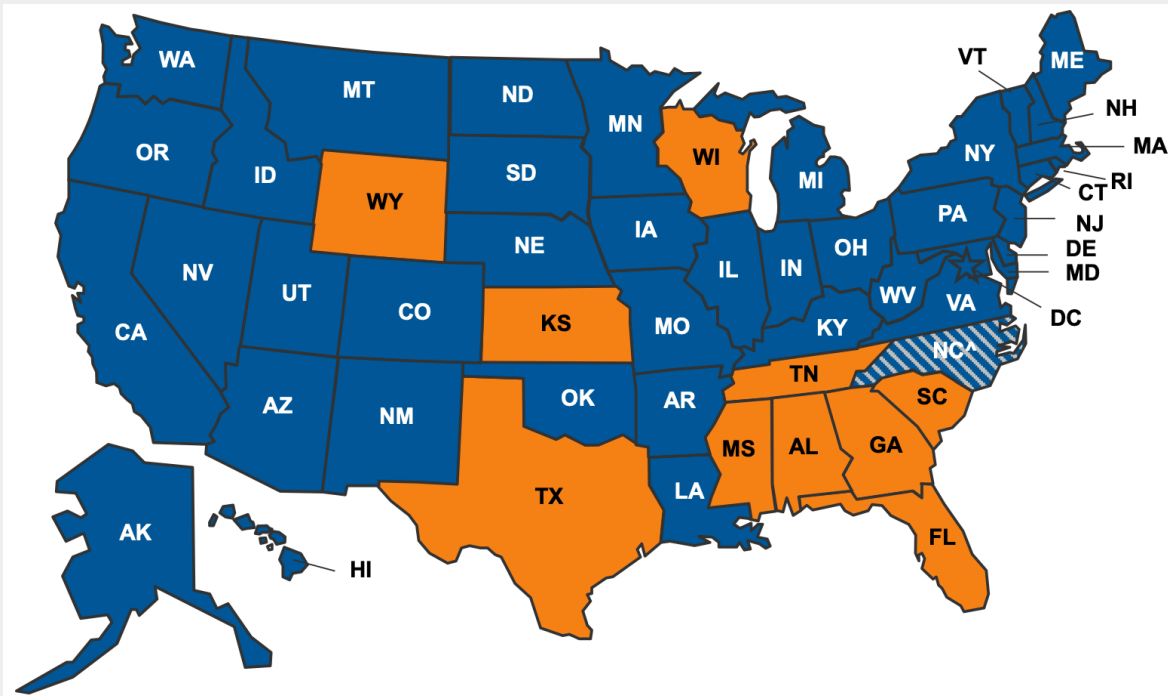
State and Local Government Spending (by Function, 2021)



Source: 2021 State & Local Government Finance Census Data and author's calculations

MEDICAID EXPANSION

As part of the Affordable Care Act (ACA), the federal government offered states a once-in-a-generation opportunity: If states expanded their Medicaid programs to cover more uninsured people, the federal government would cover up to 90 percent of the costs for that expansion. As of August July 2023, 41 states have implemented the ACA. Analysis shows that expansion states experience a substantial increase in Medicaid spending. That spending was subsidized with federal funds. In other words, the ACA did not crowd out state spending in other priority areas like education, transportation, or public assistance. More importantly, the 35 states that expanded healthcare coverage before the COVID-19 pandemic reported lower uninsured rates and were better positioned to respond to the public health emergency by providing coverage to millions of Americans who lost their job-based healthcare coverage.



Around 19 percent of state spending was on public education, including public universities, colleges, and public libraries.

Virtually every state constitution has language that calls out funding primary (Kindergarten through eighth grade) and secondary (ninth through 12th grade) public education as the state's principal responsibility. In most states, public education is delivered by local school districts but paid for in large part with local government property tax revenues and state funds distributed to school districts using formulas that factor in the number of students, student demographics, and local property wealth – all to ensure adequate and equitable funding.

State governments' direct expenditures in elementary and secondary education are nominal (\$6 billion). Direct spending is executed by local governments – often by school districts, but sometimes municipal governments or townships (\$750 billion, or 38 percent of local government spending).

State governments directly support public universities and colleges (\$264 billion); the remainder is invested by local governments in their community colleges and public libraries (\$76 billion).

State and local government investment in transportation – including highways, airports, sea and inland ports, and parking facilities – were eight percent of state government spending, with significant variation across states. Large states like Alaska and Texas dedicate up to 20 percent of their annual spending to building and maintaining highways, airports, and seaports. By contrast, New England’s state highway systems are far smaller, so state spending on transportation is not nearly as large a share of overall state spending.

State and local governments finance most of their investments in infrastructure by borrowing money – usually through municipal bonds – that they repay over time. Interest on that debt was three percent of state government spending.

Public safety was 5 percent of state government spending. For state governments, corrections (i.e., prisons, detention centers, parole officers, and state crime prevention programs) are a significant proportion of spending. Unlike local governments, state spending on police is a small share of total spending with much of that spending related to state patrols and criminal investigations.

Spending on parks, environment conservation programs, clean water initiatives, housing redevelopment, and economic development was three percent of state government spending.

Government administration – including state spending on courts, legal services, legal counseling of indigent or other needy persons, legislative bodies, and agencies concerned with tax assessment and collection, budgeting, accounting, and financial reporting was four percent of government spending.

Finally, pensions and other post-employment benefits (OPEB) for retired state government workers are one of the most important and fastest-growing components of other expenditures (three percent).

The *discretionary vs. non-discretionary* spending distinction is critically important to the states. **Medicaid and primary/secondary education are effectively non-discretionary programs.** State legislators can change their state Medicaid laws and policies, and many have. But without a policy change, Medicaid spending is formula-driven and locked in. Primary and secondary education spending is also driven by formulas that require the state to send a given amount of money to local school districts each year, barring some substantial policy change. States must also pay the interest on their debts and make good on their pension and other post-employment benefit (OPEB) promises. Taken together, non-discretionary spending for state governments is around 70 percent of total spending. That’s why when revenues fall short of expectations and states need to balance their budgets, they have little choice but to scale back on the 30 percent that remains in discretionary areas like higher education, public health programs, transportation, and government administration.

We were reminded of this fact in the Great Recession when state governments cut spending on higher education by an average of 35 percent and public health programs by an average of 50 percent. We expected history to repeat itself at the start of the COVID-19 pandemic; however, the influx of federal stimulus funds coupled and the mild recession – amid the pandemic resulted in a majority of states reporting surpluses, not deficits, FY 2021 and FY 2022.

PUBLIC PENSION PROBLEMS PERSIST!

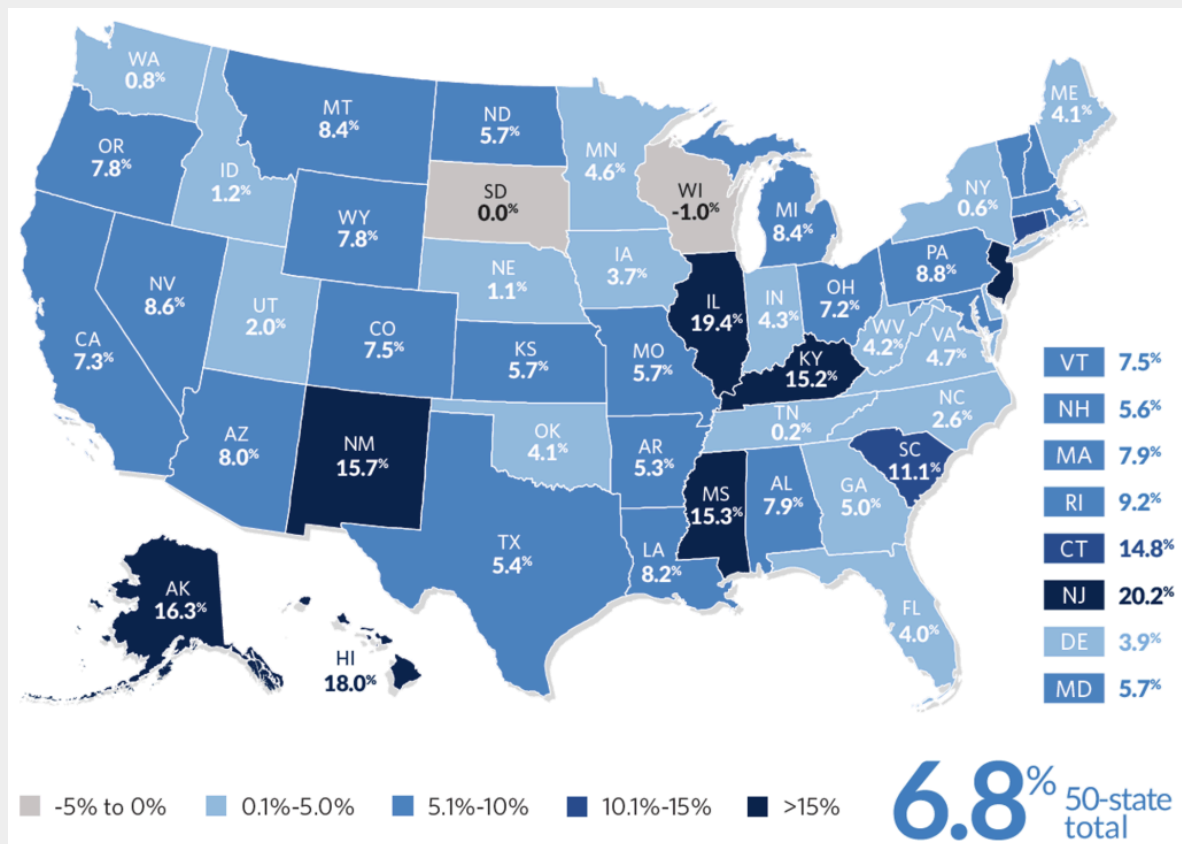
The chronic underfunding of public sector retirement systems is arguably one of the most significant fiscal challenges facing state and local governments to date. The 50-state pension funding gap – the difference between state retirement systems’ assets and projected benefit payments to employees – was **\$1.25 trillion** at the end of FY 2019 (Pew, 2022).

While the Great Recession exacerbated the public sector retirement crisis, it did not create it. Pension problems were long in the making as states opted to increase employee pension benefits in lieu of annual wage adjustments. At the same time, they failed to make their annually required contributions and instead relied on robust returns on investments and above-average discount rates to value their long-term obligation. These actions resulted in inflated assets and understated liabilities.

While reforms have faced legal setbacks, several states have been able to scale back on their plan benefits, including limiting benefits to current employees, demanding higher contributions, limiting or ending eligibility for new employees, and creating defined contribution plans or hybrid retirement plans. While policy changes represent improvements on the margin, they do not resolve plan insolvency.

Why would pension underfunding present a fiscal challenge to governments? First, pension obligations are akin to general obligation (GO) debt in that general tax dollars will be used to make payments on retiree benefits. However, unlike general government long-term debt obligations, liabilities associated with retirement benefits are less visible to the public, face no constitutional or statutory limitations, and do not require voter approval. What’s more, governments can do little to modify benefits to existing employees, retirees, or their beneficiaries once granted. Unfunded retiree benefits represent a substantial reallocation of future cash flows on what is, in essence, an unpaid historical cost.

Unfunded Pension Liabilities as a Share of State Personal Income (2019)

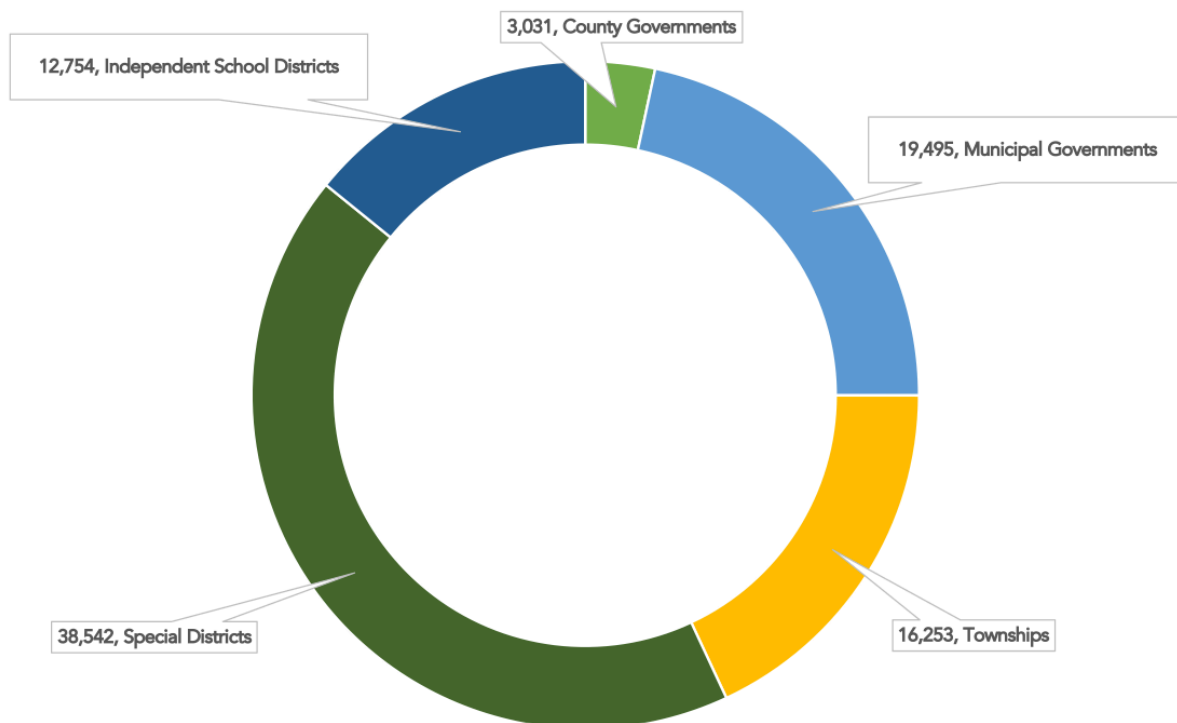


Source: Pew (2022) "States' Unfunded Pension Liabilities Persist as Major Long-Term Challenge"

LOCAL GOVERNMENTS

In addition to the federal government and the 50 state governments, the Census Bureau recognizes five basic types of local governments: counties, municipalities (i.e., cities, boroughs, and villages), townships (i.e., towns or townships), special districts, and school districts. Counties, municipalities, and townships are recognized as general-purpose governments, whereas school districts and special districts are recognized as special-purpose and single-purpose governments, respectively.⁵

Municipalities fund and manage public schools, utilities, large cash-transfer assistance programs, and major infrastructure networks. No two municipal governments are alike. Some operate their own electric utilities and water companies. Some operate golf courses, swimming pools, and other recreational facilities. Cities like Austin, Jacksonville, and Seattle have financial structures dominated by large public utilities. Some have programs to fight homelessness and promote affordable housing, both areas that until recently were managed by the state and federal governments. Others have programs to fight climate change, promote tourism, and acclimate new immigrants to their communities. Of all the levels of government, municipalities offer the most variety in their size and scope of services.



Source: 2017 State & Local Government Finance Census Data

Counties are often called the “bottom of the fiscal food chain.” They deliver expensive and human capital-intensive services like public health, elections, tax administration, and regional transit systems. In some sense, counties are the opposite of municipal governments and townships. Counties manage services where a broader geographic reach, relative to municipalities, is more practical and

5. The federal government officially recognizes the sovereignty of 573 Indian tribes in the contiguous 48 states and Alaska. U.S. territories (Puerto Rico, Guam, Northern Mariana Islands, U.S. Virgin Islands, and American Samoa) are self-governing, and each has a non-voting member of the House of Representatives. We’ve not included a discussion on the revenue structure or spending priorities of these governments in this edition of the text.

economical. Elections, for example, are usually a county function. Instead of dozens of municipalities conducting their own elections, county governments manage county-wide elections that cover all the municipal and county officials elected within the county. Tax administration is another example. Property assessors are usually positioned within a county government but execute property assessments for all the municipalities and other taxing jurisdictions within their county. For this same reason, counties are usually responsible for a majority of human service programs, including public health and mental health services.

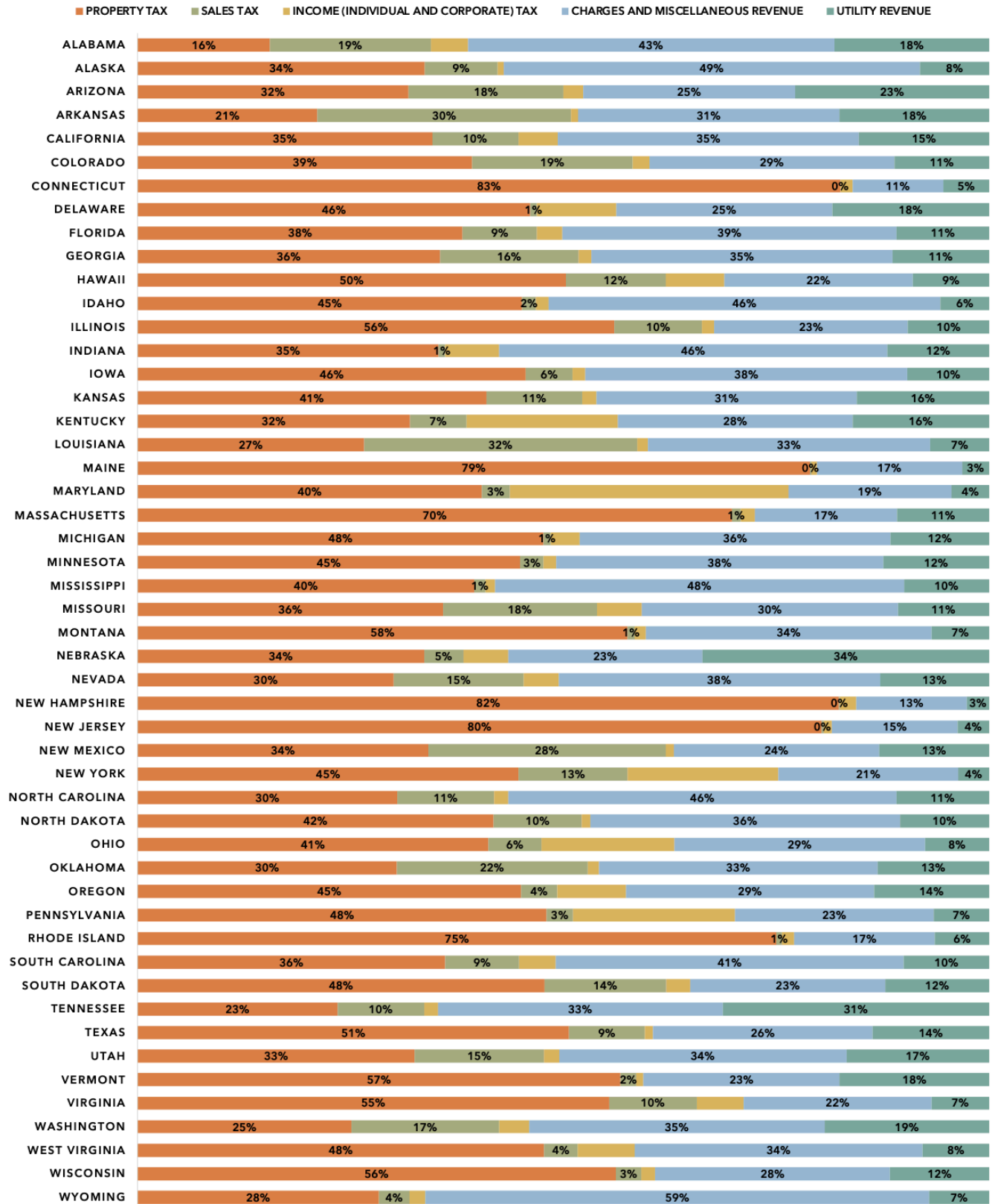
Local governments depend on the same revenue sources but in different configurations.

Property taxes are the local revenue workhorse. They are the oldest local revenue source and the only tax found in all 50 states. For the past two decades, they have accounted for at least 30 percent of all local government revenues – with significant variation across the states. There are good reasons for this. Property taxes are simple and transparent. They follow the same basic taxable base times tax rate concept you’ve already seen with both the income tax and the sales tax (see below for more details on property tax administration). And yet, property taxes are wildly unpopular. Taxpayers get angry when their tax bill increases, but their income does not. They also struggle to understand how the government determines their property value. That’s why the property tax is often called the “necessary evil” of local revenue systems.

In 38 states, the state government has authorized local governments to levy a *local sales tax*. In all, around 6,500 municipal governments rely on local sales tax revenues for seven percent of total revenues. Applicable rates and taxable bases vary. The five states with the highest average local sales tax rates are Alabama (5.25 percent), Louisiana (5.10 percent), Colorado (4.88 percent), New York (4.52 percent), and Oklahoma (4.48 percent). Some city and county governments have a general sales tax to fund local services. Other local sales taxes are much smaller rates but have more specific purposes like public education, public safety, public health, or tourism. For example, in 2000, voters in Brown County, WI, authorized a 0.5 percent sales tax to fund improvements to Lambeau Field, home of the Green Bay Packers of the National Football League (NFL).

Local income taxes are common in areas with lots of commuters. In fact, they are often called *commuter taxes* or *head taxes*. Central cities often lament commuters who work in the central city and use central city services but do not pay for those services because they own property outside the central city. Local income taxes impose a tax on wages, income, and other earnings in the jurisdiction where that income is earned. This is the logic behind local income taxes in several large cities like Birmingham, Denver, Kansas City, New York City, Philadelphia, St. Louis, and Washington, D.C. Several municipalities in greater Portland impose a local income tax to help fund Tri-Met, the regional light rail system. This is an interesting twist on the commuter tax model. Ohio authorizes all its municipal governments to levy a local income tax. The central criticism of local income taxes is that they drive away business. That is, if a local business can avoid paying the local income tax simply by moving to another jurisdiction, it will have a strong incentive to do so.

Local Government Own Source Revenues (by Source 2021)



Source: 2021 State & Local Government Finance Census Data and author's estimates.

JUMPSTART SEATTLE

Two years after passing and then repealing the head tax (planned to be \$275 per employee), the Seattle City Council approved a new payroll tax. Christened “JumpStart Seattle,” the city’s payroll ordinance imposes a tier-rate payroll tax on businesses with annual payrolls of more than \$7 million on a sliding scale from 0.7 percent on employee wages between \$150,000 and \$399,999 up to 2.4 percent, with the highest rates applying to employees reporting income in excess of \$400,000 who are employed by businesses with more than \$1 billion in annual payroll expenses. However, unlike the OASDI, this payroll tax is a tax on the employer, even though the basis of the tax is employee wages.

Businesses with payroll expenses of less than \$7 million, grocery stores, insurance businesses, certain motor vehicle businesses, federal, state, and local government entities, and independent contractors whose compensation is included in the payroll expense of another business that is subject to the tax are exempt from the payroll tax. Additionally, not-for-profit healthcare entities are exempt from the payroll tax on employees with annual compensation of \$150,000 up to \$400,000 for the period January 1, 2020, through December 31, 2023.

The tax, which was expected to yield \$210 million in its first year, brought in more than \$230 million. Revenues from the tax were used to mitigate the effects of the COVID-19 public health and economic crisis and finance affordable housing investments and equitable development projects in the future.

Local governments depend on a variety of *intergovernmental revenues*. Many state governments offer municipalities grants to fund a variety of needs, especially infrastructure. States have *revolving loan* programs to help city and county governments pay for roads, bridges, drinking water systems, stormwater management systems, and other basic infrastructure.

Federal intergovernmental revenues also assist municipalities with transportation infrastructure, affordable housing, community development, community policing, and many other initiatives. In a few states, municipalities receive up to 40 percent of their revenues through state revenue-sharing programs. This is most common in states where local governments are not authorized to levy a local sales tax or are subject to strict property tax limits.

Municipalities also employ dozens of “other” revenue sources. Some tax utilities, both publicly owned and privately owned, are within their borders. Municipalities also impose fees on licenses for everything from owning a pet to operating a tavern to practicing massage therapy. Municipal courts also impose a variety of fines on everything from illegal parking to vagrancy.

Like the sales tax, fees and other miscellaneous charges have become a much larger part of municipal revenue portfolios. These revenue streams are regressive, and their proliferation exacerbates income inequality.

PRIMER ON PROPERTY TAX

The property tax is the most important tax used by local governments, accounting for about 70 percent of local government tax revenues and 30 percent of all local government revenues. The property tax is also politically unpopular. The unpopularity of the tax is based on its visibility. Taxpayers get angry when their property tax bill increases when their incomes have not, and they struggle to understand how the government estimates the value of their property. Even though the tax remains an essential source of revenue for local governments, it remains unpopular, and voters have shown their disdain for the tax with their support of property tax limits (see Tax and Expenditure Limits).

Property taxes apply to **real property**, including land and buildings, and **personal property**, including moveable items such as cars, boats, and value stocks and bonds – although most states have moved away from taxing personal property and now impose taxes on real property.

In its simplest form, the property tax is calculated by multiplying land and buildings' value by the property tax rate. Property tax rates are typically expressed in mills (a mill is one-tenth of one percent). An owner of property worth \$250,000 subject to a 10 mill (i.e., 1 percent) tax rate would pay \$2,500. In reality, property taxes are often more complicated.

First, local governments must determine the property's value for tax purposes. Tax assessors use statistical models to estimate the property's market price using prices of recently sold properties. They then multiply the estimated market value by an assessment ratio ranging from 0 percent (meaning the property is exempt from the property tax) to 100 percent (indicating full-value assessment) to arrive at the property's assessed value.

$$\text{Market Value} \times \text{Assessment Ratio} = \text{Assessed Value}$$

While many states use market value (an assessment ratio equal to 100 percent), others assess property at a fraction of its actual value. For example, a state may have a 100 percent assessment ratio for commercial property and a 70 percent assessment ratio for residential property, which means a \$250,000 commercial property is taxed on its full market value, but a \$250,000 residential property is taxed as if it were worth \$175,000. States may have exemptions or credits that are available to certain types of properties or property owners. Homestead exemptions, for example, reduce the amount of property subject to taxation. This exemption is limited to owner-occupied homes. For a home worth \$250,000 subject to fractional assessment (at an assessment ratio of 70 percent), the home would be taxed as if it were worth \$125,000 ($\$250,000 \times 0.70$)-\$50,000).

$$\text{Assessed} - \text{Exemptions} = \text{Taxable Value}$$

The millage rate, usually the sum of tax rates of several jurisdictions (e.g., county tax, city tax, school district tax, special district tax (for hospitals, parks, libraries, etc.)), is then applied to the assessed value (net of exemptions). Assuming a millage rate of 10 mills (or \$10 per \$1,000 in assessed value), the property tax bill of a \$250,000 commercial property is \$2,500. In contrast, the property tax bill of residential property, subject to a 70 percent assessment ratio and whose owners are eligible for the homestead exemption, is \$1,250 (i.e., $\$125,000 \times 0.01$).

$$\text{Taxable Value} \times \text{Millage Rate} = \text{Tax Liability}$$

States may provide means-tested tax credits that lower the property tax liability.

$$\text{Tax Liability} - \text{Credits} = \text{Property Tax Owed}$$

More importantly, the fractional assessment, homestead exemption, and property tax credits result in a lower effective tax rate for homeowners. The effective tax rate is equal to the actual property tax payment divided by the property's market value. For the owner-occupied residential property, the ETR is 0.5 percent (i.e., $\$1,250/\$250,000$). ETR for commercial property not eligible for the exemption and assessed at full value is 1.0 percent (i.e., $\$2,500/\$250,000$).

Local government expenditures in 2021 were \$2.2 trillion; most of it was spent on primary and secondary education, social services, and public safety.

Public education accounts for around 40 percent of local government spending. In 2021, local

government invested \$750 billion in elementary and secondary education, \$46 billion in community colleges, and \$13 billion in public libraries.

Social services were 12 percent of local government spending. As we noted earlier, Medicaid and mean-tested cash assistance programs are all administered by state governments. Local governments are responsible for funding and investing in public hospitals (\$130 billion) and healthcare programs (\$69 billion), including spending in public health departments that lead disease prevention and health promotion efforts such as vaccination programs, food safety, and disaster preparedness and response.

Local governments spent \$216 billion (10 percent) on *public safety*, including police (\$116 billion), fire (\$61 billion), and corrections (\$32 billion). Public safety is one of the fastest-growing spending areas but ranks third behind local government investment in public education and social services. Spending on police today remains at the same level it was in 1959 – at about 4.8 percent – even though crime rates are at their lowest point in decades.

The remainder of local government spending is spent on municipal infrastructure, economic development, government administration, and employee benefit programs. Municipal infrastructure includes investments in streets, sidewalks, bridges, drinking water treatment, wastewater treatment, stormwater management, electricity, cable television, and broadband. Many of our most basic human needs are met by municipal infrastructure. Economic development includes programs to encourage small business growth, promote arts and culture, make neighborhoods safer and more walkable, and provide affordable housing, among others. The remainder is the interest expense on long-term debt issued to finance municipal infrastructure.

As mentioned above, the priorities of local governments around the country have expanded dramatically in the past two decades. Today, local governments have programs and services designed to mitigate climate change, stop the nationwide opioid epidemic, protect the civil rights of the LGBTQ community, prepare recent parolees for careers in emerging industries, promote international trade, and assist newly arriving refugees. In the past, these issues were considered state, national, or even international issues. What difference can a city make, the argument went, around a problem so vast as climate change? But in the midst of chronic political gridlock in state capitals and in Washington, D.C., and in a new environment where “symbolic politics” are more potent than ever, many municipal officials feel compelled to go it alone.

TAX AND EXPENDITURE LIMITATIONS (TELS)

At the local level, TELS are either limits on the property tax rates, growth in the property tax base (or assessed value), property tax revenues, or the aggregate of local government taxing or spending authority.

Limits on assessed valuation are limits on annual growth in the valuation of the property (e.g., two percent), while limits on property tax revenues are dollar limits on the total amount of revenue that can be raised from the property tax. Caps on the aggregate of local government taxing or spending authority are dollar limits on overall spending authority. The limits can apply to all governments with taxing authority or specific municipalities (e.g., school districts).

The first property tax limit that is still in effect today was adopted in Alabama in 1875. Adopting restrictive property tax limits protected white landowners from new or higher property taxes intended to fund education for Blacks, who were largely untouched by property taxes since they owned very little real or personal property. Alabama was not alone. Arkansas, Georgia, Missouri, and Texas adopted restrictive property tax limits – some of which remain in the books now.

At the state level, TELS restrict the growth of government revenues or spending. In estimating limits on spending authority, the state is required to establish base-year appropriations subject to the limit and adjust for a factor of growth that is equal to changes in population, inflation, or personal income. States can only exceed appropriation caps if they exercise the override provision, which often is a legislative majority or super-majority vote.

Funds in excess of the limitation are refunded to taxpayers, deposited in a reserve fund (commonly referred to as a rainy-day fund), or used for purposes as provided by law (e.g., capital improvements, K-12 spending).

In addition to limits on appropriations, state governments mandate a legislative supermajority vote or voter approval before the state can adopt new or higher taxes. Mississippi was the first state to adopt a legislative supermajority requirement – and to date, any tax increase must secure three-fifths of votes in both houses of the legislature. Sixteen states have since adopted legislative supermajority or voter approval requirements, thereby limiting the government's ability to raise additional tax dollars or engage in meaningful tax reform.

While these revenue suppression measures remain popular, they have had unintended and perhaps detrimental effects, especially at the local level. For example, data from 1977 through 2007 – when a number of property tax limits were adopted in the states – shows the precipitous decline in property tax revenues as a share of own-source revenues. In California, Massachusetts, and Oregon, revenues from property taxes fell more than 15 percent. In response, local governments have come to rely more on intergovernmental transfers and user charges and fees. They have also adopted local option sales and/or income taxes to make up for lost property tax revenues. The extensive reliance on user charges and fees without a progressive income tax means state and local government tax structures are regressive.

For local governments, revenues are now more volatile, and they have less control over their budgets than they did prior to the tax revolt movement. TELS have also altered how local governments are willing to borrow, market perceptions of their credit quality (or default risk), and their ability to manage their other long-term obligations and legacy costs.

Recommended Reading: Michael Leachman, Michael Mitchell, Nicholas Johnson, and Erica Williams (2018) “*Advancing Racial Equity with State Tax Policy*” Center for Budget and Policy Priorities

SPECIAL DISTRICTS

Special districts are independent, special-purpose government units created for a limited, specific purpose with substantial administrative and fiscal independence from general-purpose governments. They are called many different things, including *public authorities*, *off-budget entities*, *special-purpose districts*, *autonomous governments*, *special taxing districts*, and *public corporations*. Authorized by their respective state governments, special districts deliver a wide variety of services, including fire protection, parks, parking facilities, libraries, electric power, water supply, sewerage and solid-waste management, cemeteries, airports, community colleges, industrial development, affordable housing, hospitals, and sea and inland port facilities.

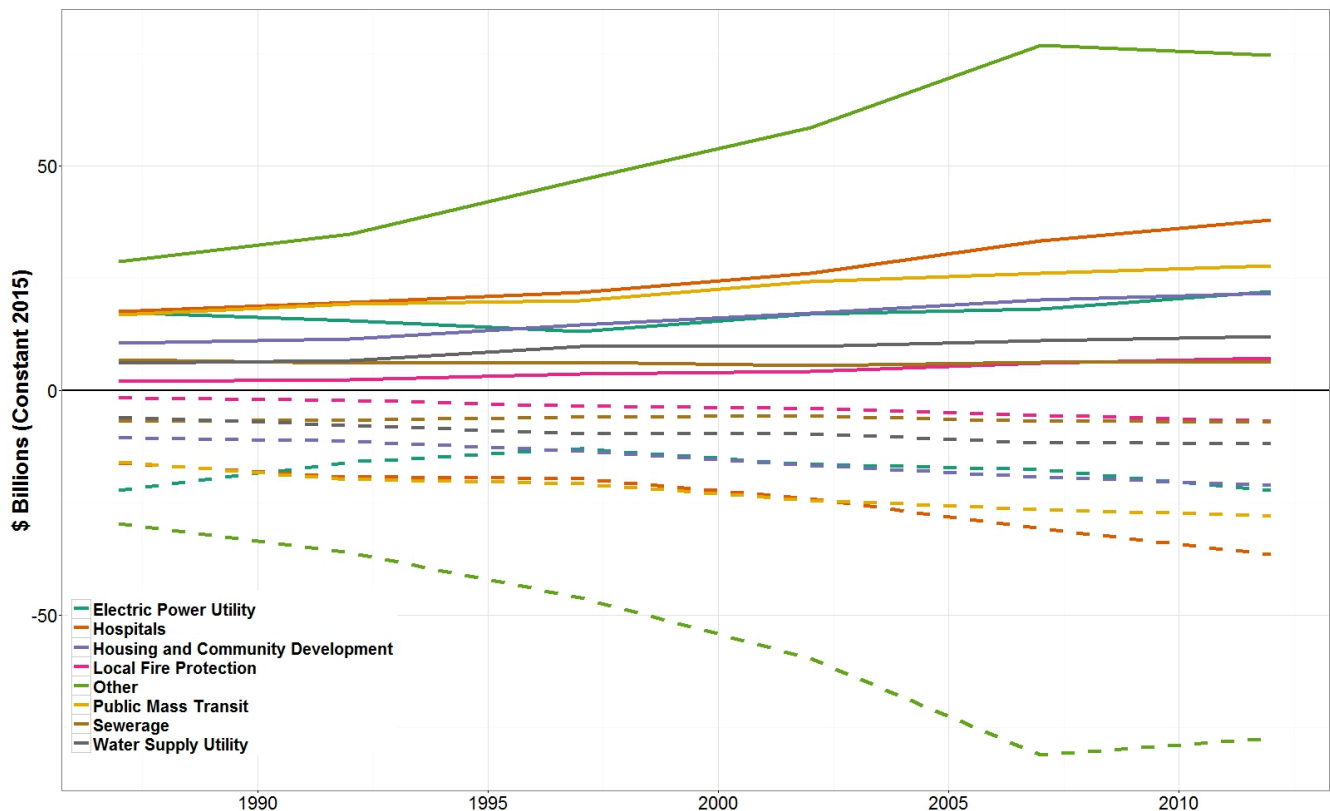
Consider the following examples:

- The *Milwaukee (WI) Metropolitan Sewerage District (MMSD)* is a regional agency that provides wastewater and stormwater management services for about 1.1 million people. Its service area covers 411 square miles and includes six watersheds. It is one of the largest urban sewerage districts in the country. In 1996, it contracted out most of its basic operations to the private firm United Water, making it the largest urban sewer system in the U.S. under private management. It collects revenues from charges to businesses and homes that use its sewer system, a 0.5 percent property tax on all land within the district, state and federal grants, and sales of “Milorganite,” an organic compost product it developed and patented, among other revenue sources. In 2015, it spent \$252 million and employed 1,200 people.
- The *Port of Seattle (WA)* manages one of the fastest growing airports in the world (Seattle-Tacoma International Airport), the third largest cargo container port on the West Coast, an \$8 billion real estate portfolio, and a variety of technical education programs that train young people to work in the maritime and aviation industries. It employs 2,200 people, and in 2022, it spent \$573 million. It collects revenues from rental fees paid by airlines and shipping companies, fees on cargo and airline passengers, and real estate rentals and sales. It also has the authority to levy a property tax.
- The *Barberton-Norton (OH) Mosquito Abatement District* manages populations of “biting arthropods” across 60 square miles of northeast Ohio. In its own words, the district is successful if “you can prepare a picnic, play cards by moonlight, even sit on your front porch without the hassle of mosquitoes.” It employs three full-time staff. Its sole revenue source is a 0.05 percent property tax.
- The *Holley-Navarre (FL) Fire District* began as a volunteer fire squad with no equipment or funding. It operated from 1965 through 1980 using borrowed equipment and was funded solely by donations. In 1980, the district was created by a special act of the Florida legislature. Today it covers approximately 50 square miles in the Florida “panhandle,” with 30 full-time firefighters across four fire stations. In 2021, it spent \$2.8 million. Revenue for the fire district comes from property taxes and *impact fees*, an excise tax levied on the assessed value of new construction.
- The *New Jersey Sports and Exposition Authority (NJSEA)* is the planning and land use agency for a 30-square-mile area just across the Hudson River from New York City. It was created in 1971 to develop sports and entertainment facilities near the “Meadowlands,” a marshy and heavily polluted former industrial area (see the opening credits of *The Sopranos*). Today, it manages Met Life Stadium (home of the New York Giants and New York Jets of the NFL), IZOD Arena (former home of the New Jersey Devils of the National Hockey League), and several other racetracks, convention facilities, aquariums, and amusement parks. In 2015 the New Jersey Meadowlands Commission, the authority originally tasked with land use planning and restoration of the Meadowlands, was folded into the NJSEA. As a result of that merger, the NJSEA now delivers services that include planning, zoning, floodplain management, solar energy, methane recovery, a marina, and pontoon boat cruises. In 2021 it employed 95 full-time staff and spent \$102 million. It derives most of its revenue from rental fees and leases and a local tourism tax paid on hotel rooms and rental cars.

- The *Utah Housing Corporation* is a statewide authority created by the Utah legislature in 1975. Its mission is to raise funds to make housing affordable for lower-income Utah households. It does this mostly by offering home loans – or *mortgages* – to first-time home buyers and to developers building or renovating affordable apartment projects. The Authority is self-supporting and raises hundreds of millions of dollars each year through partnerships with banks, real estate developers, realtors, and others. In 2022 it employed 104 people and spent \$55 million. It collects interest payments on its mortgages, buys and sells mortgages for a profit, and receives corporate donations.

In 1977 there were just under 26,000 special districts in the U.S. Today, there are just under 40,000. The figure below shows the growth in special district revenues and spending from 1977-2012. Solid lines represent revenues, and dashed lines represent spending for eight different special districts, including electric power, hospitals, housing and community development, fire protection, mass transit, sewerage, and water supply. Most districts increased their total revenues and spending by 30-75 percent during this period. Revenues and expenditures in the “other” category, including soil and water conservation, libraries, cemeteries, parks, and recreation, increased more than 200 percent over the same period.

Special District Revenues and Spending (1987-2012)

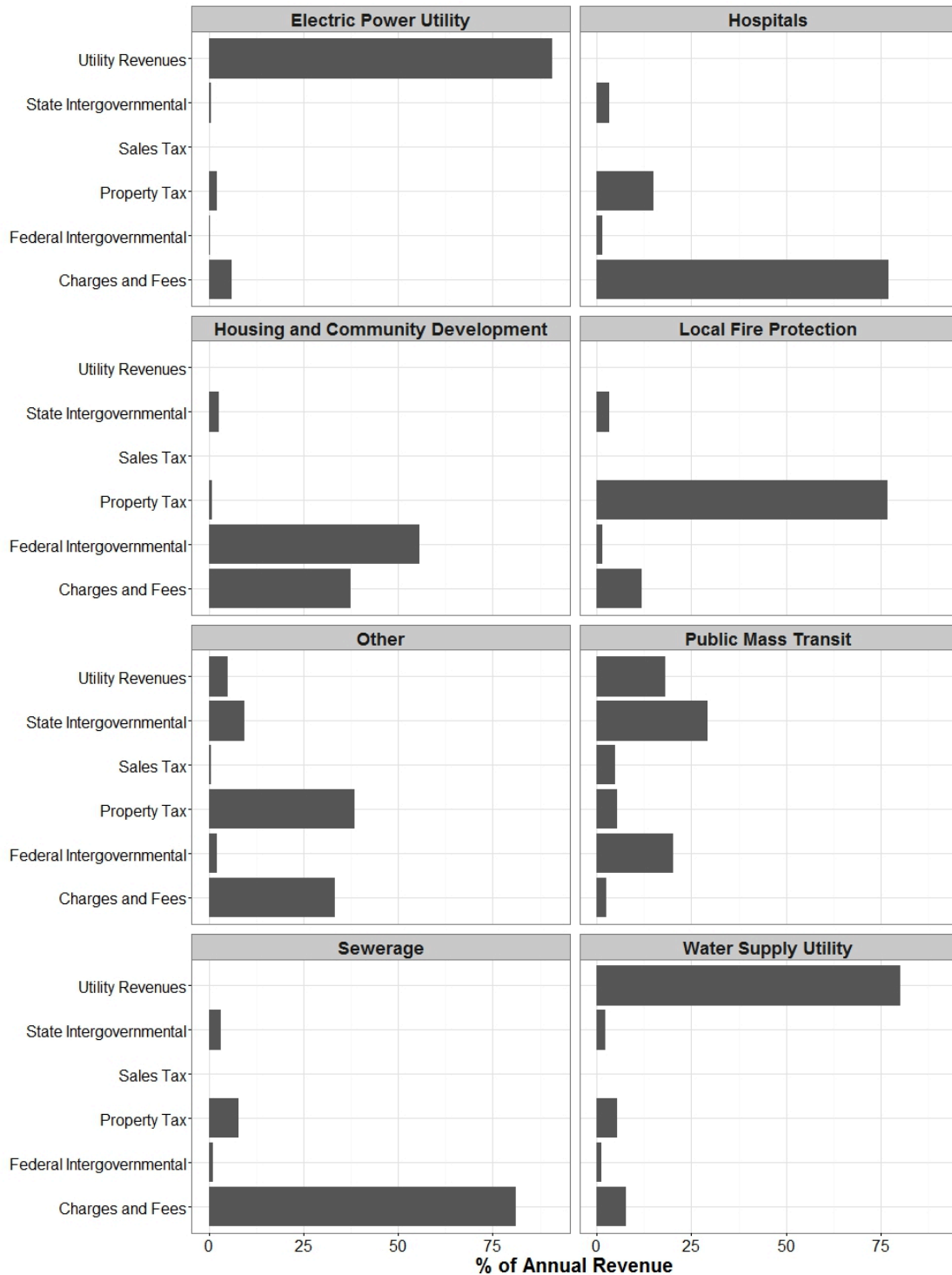


Source: U.S. Census of Governments Data and author’s estimates (excludes School Districts). Note: Like state and local governments, special districts balance their budgets; as such, their revenues exceed expenditures.

The next figure shows the composition of special districts’ revenues. It shows each revenue source as a percent of total revenues for special districts by type. For example, in 2012, public hospitals derived 77 percent of their revenues from charges and fees. In other words, a typical hospital earns revenue

by collecting fees from patients (and patients' health insurers, including Medicare and Medicaid). Public hospitals levy property taxes (12 percent) and receive federal (4 percent) and state (7 percent) intergovernmental revenues. Utility districts are authorized to deliver electricity to customers and collect fees in exchange.

Revenue Composition of Special Districts (2012)



Source: U.S. Census of Governments Data and author's estimates. Note: Figures may not add up to 100 percent due to rounding and excluding smaller categories.

This chart's key takeaway is that most special districts depend on one or two main revenue sources. This is not a coincidence. State and local legislatures typically grant special districts limited revenue authority, and few can levy a tax or receive funding from the state. In fact, special districts are engaged in business-type activities where they deliver a specific service in exchange for a fee. This is quite different from state and local governments, where taxpayers pay general revenue sources like property and sales taxes and receive general services like public safety and public health.

What accounts for the explosive growth of special districts? Two, sometimes contradictory factors. First, special districts allow for more direct taxpayer control. Suppose citizens receive a service through their municipal or county government, and they wish to change how they pay for that service or how that service is delivered. In that case, they can only affect that change through their city councilmember or other local representatives who must also attend to dozens of other service delivery concerns. With special districts, citizens elect a separate governing body that attends only to that specific service, and they pay taxes or fees dedicated to that service. The relationship between governance, funding, and service delivery is, in concept, much clearer.

Fire protection is a good example. Citizens in unincorporated areas (i.e., areas that fall outside the boundaries of any municipality) often receive fire protection from a county government or nearby municipality. In the event of a fire, they would rather not wait for the county or nearby municipal fire service to arrive. They'd much rather have local firefighters who understand the local terrain and offer services that a municipal or county fire service is less likely to deliver (e.g., wilderness rescue, wildfire prevention, and outreach). So, they create a local fire protection district, pay property taxes specific to that district, and elect a fire protection district board. We see a similar dynamic in service areas like flood control, agricultural irrigation, and parks. It is also quite common in the Western U.S., where local political culture tends to favor populist, local control of government. For example, while Tennessee and Washington have roughly the same population, Tennessee has 347 municipal governments and 475 special districts, whereas Washington has 281 municipal governments and 1,670 special districts.

Special districts have also proliferated because they can help citizens circumvent tax and expenditure limitations. Sometimes those limitations are political. For instance, taxpayers across the country have voted often to move traditional municipal services like libraries and parks from their municipal government to a special district. When these services are delivered through a special district, they have a dedicated revenue source. They need not compete with public safety, roads, water/sewer, and other municipal services for limited tax dollars. And sometimes, those limitations are legal. For example, school districts in many states must get voter approval for new school buildings. Before the district can borrow money to build, voters must approve the additional property taxes needed to pay back that borrowed money. Voters are reticent to support additional property taxes. So, as an alternative, a district can authorize the creation of a school building authority. That authority will borrow money, build the new school building, lease the building to the district, and then repay the borrowed money with the school district's lease payments. At one point in the early 2000s, nearly half the public school buildings in Texas were financed through this "leaseback" model.

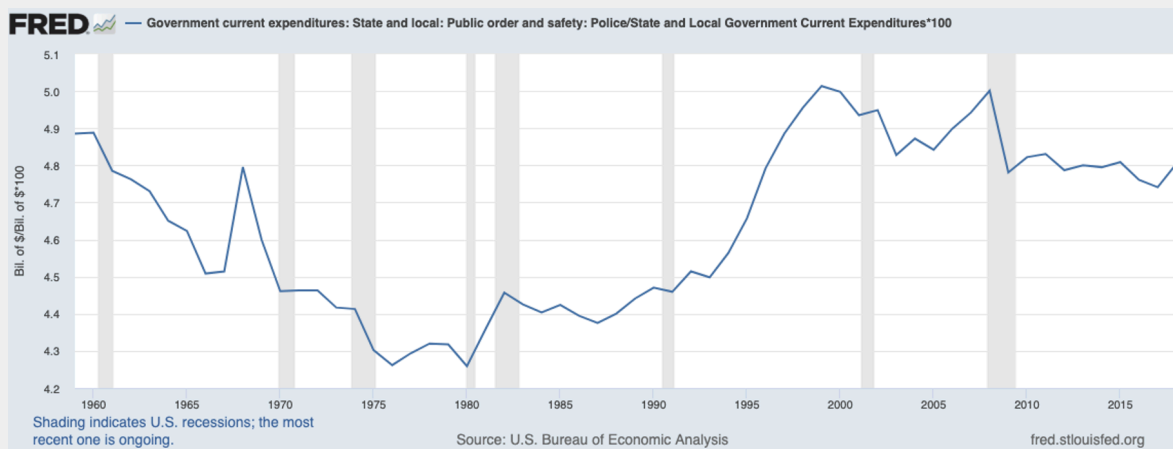
This proliferation presents a variety of trade-offs for governance and accountability. Special districts do offer more local control, but the evidence suggests they often do the opposite. Voter turnout for special district elections is usually among the lowest for all elected offices. Academic research shows

that citizens rarely know that special districts even exist and almost never know who they voted for in the last election. So, there is little evidence that special districts offer better democratic accountability. Another practical concern is that the proliferation of special districts has drastically increased the total amount of local government debt outstanding. This raises a variety of concerns about whether local governments are able to repay those debts.

DEFUND THE POLICE

The opening salvo to this chapter is the story of Michael Brown, a teenager and a resident of Ferguson, who was shot and killed by a police officer who was investigating a nearby robbery. The deaths of George Floyd, Breonna Taylor, and other Black Americans have once again raised questions about police training, tactics, and priorities, especially with respect to their interactions with communities of color. One response to these tragedies is calls to “defund the police.” Defunding the police means different things to different communities – but at its core, it is a call for police reform that would divert funds from police budgets to community health, economic development, and other services to address the root causes of crime.

The Defund the Police movement has raised many important questions about how local governments spend money and what that spending says about their priorities. Perhaps most importantly, it's shown that those priorities can be radically different from one neighborhood to the next. Local government spending on public safety (i.e., policing, fire, and corrections) ranks third behind spending on education and social services. The chart below shows that spending on policing today remains at the level it was in 1959 – even though today's crime rates are at their lowest point in decades.



Source: U.S. Bureau of Economic Analysis and <https://fredblog.stlouisfed.org/2020/06/government-spending-on-police/>

Revenues from the criminal justice system have become an essential part of local government budgets. The DOJ's formal investigation of the fatal shooting of Michael Brown found that the city's law enforcement practices were shaped by its focus on revenue rather than on public safety. Ferguson's practices may have been more aggressive than some other police departments. Still, many local governments have come to rely on fines, fees, and penalties for revenues even though the incidence falls disproportionately on the poor and communities of color. In other words, defunding the police also means, to a degree, defunding other parts of local government.

While much of the public debate has focused on defunding the police in the face of police brutality, few have focused on how ineffective many police departments are at doing what they are supposed to do – solving crime. Data shows that approximately 38 percent of murders, 48 percent of aggravated assaults, 66 percent of sexual assaults, and 70 percent of robberies go unsolved. Even though budgets define responsibilities and can be used to hold agencies accountable, more often than not, police are also asked to respond to everything from loose dogs to disciplining children in our public schools. Police advocates and critics alike agree that “policing” resources are not allocated to their best use.

Now that you have a better grasp of where the money comes from and where it goes, you'll recognize the complexities in the call for defunding police. One immediate complication is differences in the scale of spending. Many experts have argued that underserved communities need massive investments in public schools and in social services like community health and affordable housing. Recall that local governments collectively spend orders of magnitude more money on schools and social services than they spend on public safety. Because of that, even a massive reallocation of public safety resources would do little to qualitatively increase spending in areas where it's most needed. For some defund policing advocates, that redirection would symbolize an important shift in priorities, even if the actual impact was minimal. But any serious attempt to address the needs of underserved communities will acknowledge that defunding the police is, at most, a partial solution. Another challenge is to define what services the police will provide with lower budgets and whether some of their existing responsibilities will be shifted to other organizations in the local government. What changes will lead to police using their budgeted resources more efficiently and effectively?

When we put the movement's goal and tactics in the context of local revenues and spending generally, it is clear that achieving its broader goals requires more than just reallocating police budgets. That will require careful attention to local governments' overall revenues and spending, what a fiscally sound local government looks like, what it costs to deliver public services, what it means to deliver those services cost-effectively, and how local budget politics and processes reinforce or upend existing policy priorities. Those are precisely the questions you'll grapple with throughout this textbook.

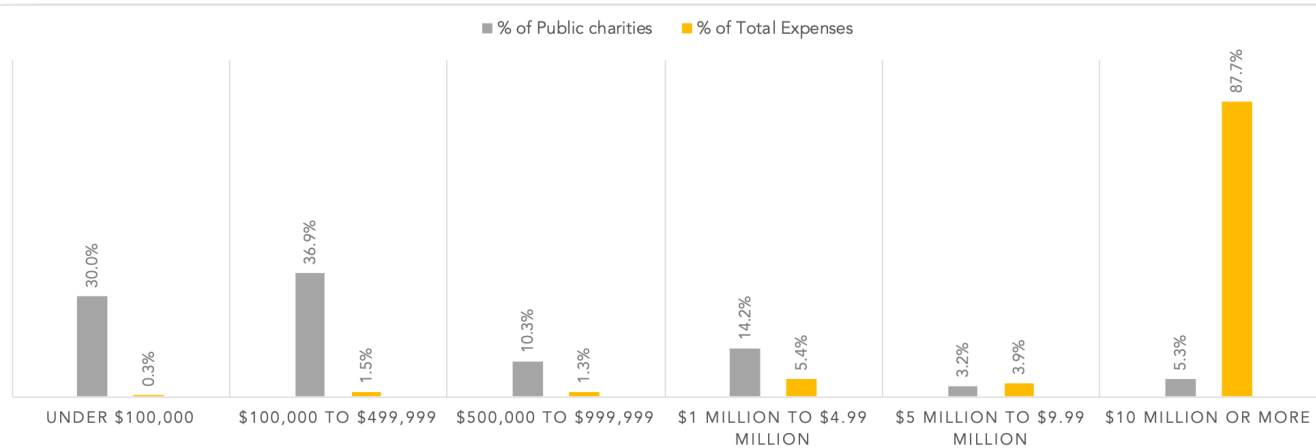
THE NON-PROFIT SECTOR

Non-profits are big business! According to the National Center for Charitable Statistics, approximately 1.54 million non-profit organizations were registered with the Internal Revenue Service at the end of 2016. Note that not all non-profits are registered with the IRS; therefore, the total number of non-profit organizations in the U.S. is unknown. The sector collectively reported \$5.99 trillion in assets and \$2.62 trillion in revenues and contributed an estimated \$1.05 trillion to the U.S. economy (5.6 percent of the nation's GDP).

Public charities are the largest category of more than 30 types of tax-exempt organizations (totaling 1.08 million in 2016) – a majority of which are small, therefore, not required to file tax forms with the IRS (i.e., Form 990, Form 990-EZ, or Form 990-PF).

The figure below presents an analysis of public charities by size. Just over three-quarters of reporting public charities – i.e., those reporting expenses of less than \$1 million – altogether account for 2.1 percent of total expenses. In contrast, charitable organizations reporting \$10 million or more in revenues reported the largest share of expenses (88 percent) even though they were a smaller share of the sector (5.3 percent).

Number and Expenses of Public Charities (as a Percentage of All Reporting Public Charities and Expenses)



Excludes organizations reporting \$50,000 or less in revenues. Source: Urban Institute, National Center for Charitable Statistics, Core Files (Public Charities, 2016).

To understand where non-profits get their money and where their money goes, you must first understand the many different types of organizations that comprise the “non-profit sector.” The table and charts below illustrate some of these differences. A few key trends stand out. Healthcare organizations have an outsized role in the sector. Even though they represent 12 percent of organizations, they account for 59 percent of the sector’s revenues and 43 percent of assets. The Kaiser Foundation Health Plan, together with Kaiser Foundation Hospitals, for example, reported \$68 billion in expenses at the end of FY 2016. That has since grown to \$97 billion at the end of FY 2022.

Education non-profits (including private schools, universities, and parent-teacher associations) were 17 percent of non-profits but were an oversized share of the sector’s assets – 33 percent. That includes not only the physical assets (e.g., academic buildings and student housing) but also financial investments. The President and Fellows of Harvard College is a permanent endowment that supports professorships, financial aid, and student activities at Harvard University. At the end of FY 2021, the university reported \$60 billion in investments (\$72 billion in total assets) – the largest of any private university. The Bill and Melinda Gates Foundation, the largest U.S. foundation, reported \$67 billion in long-term investments and \$68 billion in assets.

These non-profits defy the conventional wisdom that “non-profit” means “not profitable.” How can an organization be that large and profitable yet remain “non-profit”? That’s because the term “**non-profit**” refers to the organization’s tax status, not its business model. By law, non-profits do not pay federal, state, or local taxes on their net income – except UBIT – that is, unrelated business income tax paid on income earned on activities that are not substantially related to furthering the exempt purpose or the organization. They also receive tax-free charitable donations from individuals and corporations. We grant them these benefits because they deliver goods and services that would benefit the public. Most non-profit hospitals accomplish this by offering free or low-cost healthcare to people who can’t afford it. As long as they provide that service, there’s little restriction on how much profit they can earn. For public sector organizations, profits are not central to resource allocation. However, as you’ll see in Chapters 2 and 3, profits are essential to their long-term financial health.

Ten Largest Public Charities by Subsector, 2016

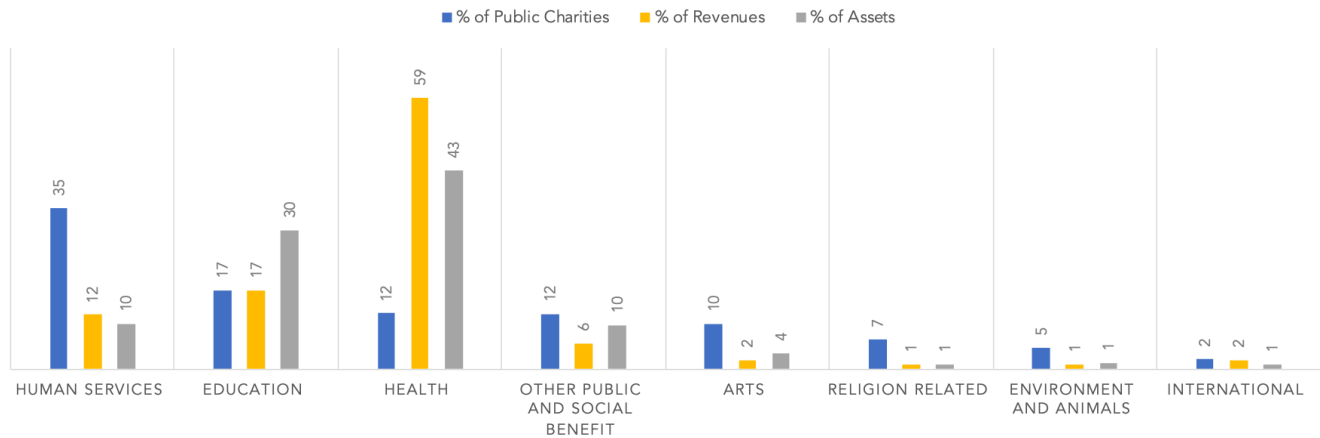
All		Human Services		Higher Education		Environment		International	
Kaiser Foundation Health Plan Inc	48,252,710,912	American National Red Cross Shared Services Center	2,886,003,368	New York University	5,420,536,806	National Geographic Society	422,501,093	Gavi Alliance	1,813,161,781
Kaiser Foundation Hospitals	20,177,137,580	Feeding America	2,041,987,389	Johns Hopkins University	5,413,130,000	Wildlife Conservation Society	246,807,085	Food for The Poor Inc	1,158,339,554
Partners Healthcare System Inc Affiliates Group Return	10,735,291,530	Park Nicollet Group Return	1,368,839,756	Trustees of The University of Pennsylvania	5,365,056,000	Zoological Society of San Diego	244,952,106	World Vision	993,127,196
UPMC Group Return	10,397,939,016	Partnership for Supply Chain Management Inc	1,142,152,752	The Board of Trustees of The Leland Stanford Junior University	5,050,927,315	World Wildlife Fund Inc	225,035,121	Americares Foundation Inc	982,086,854
Dignity Health	9,598,768,323	National Collegiate Athletic Association	908,806,647	President and Fellows of Harvard College	4,775,458,754	New Venture Fund	214,351,188	Institute of International Education Inc	830,196,153
Cleveland Clinic Foundation Group Return	7,031,439,782	Navigate Affordable Housing Partners Inc	553,684,120	University of Southern California	4,257,472,819	National Fish & Wildlife Foundation	208,519,799	Nature Conservancy	796,011,941
Ochsner Clinic Foundation	6,546,010,317	Southeastern Conference	510,200,575	Vanderbilt University	4,189,634,110	American Society for the Prevention of Cruelty To Animals	190,082,947	Compassion International Incorporated	787,035,423
New York State Catholic Health Plan Inc	6,241,795,918	Big Ten Conference Inc	436,043,240	Trustees of Columbia University in The City Of New York	4,139,274,346	Ducks Unlimited Inc	186,270,439	Direct Relief	716,768,367
CareSource	6,013,922,970	PAC 12 Conference	435,057,356	Cornell University	3,951,934,873	The Conservation Fund A Nonprofit Corporation	179,485,477	Plan International Inc	689,494,953
Banner Health	5,428,669,563	Community Care Inc	413,060,083	Yale University	3,513,798,862	Center for Sustainable Energy	172,041,689	International Rescue Committee Inc	673,939,914

Source: Urban Institute, National Center for Charitable Statistics, Core Files (Public Charities, 2016).

Human service organizations (including food banks, homeless shelters, and youth and family service social service organizations) were the most common type of non-profit (35 percent of public charities). However, they reported a significantly lower share of the sector’s revenues and assets (12 percent and 10 percent, respectively). They are also more likely to rely on individual contributions, foundation grants, and government contracts. As you’ll see in Chapter 3, human service organizations do not report sizeable investments or endowments, and given the demand for services, they are more likely to report operating deficits.

The largest human service organizations – American Red Cross, Feeding America, Park Nicollet Group, Partnership for Supply Chain Management Inc., Navigate Affordable Housing Partners Inc., and Community Care – provide access to food, affordable housing, and medical care. However, intercollegiate sports associations (i.e., the NCAA, SEC, and PAC 12) are registered as non-profits and among the ten largest human service organizations!

Public Charities Revenues and Assets by Subsector, 2016

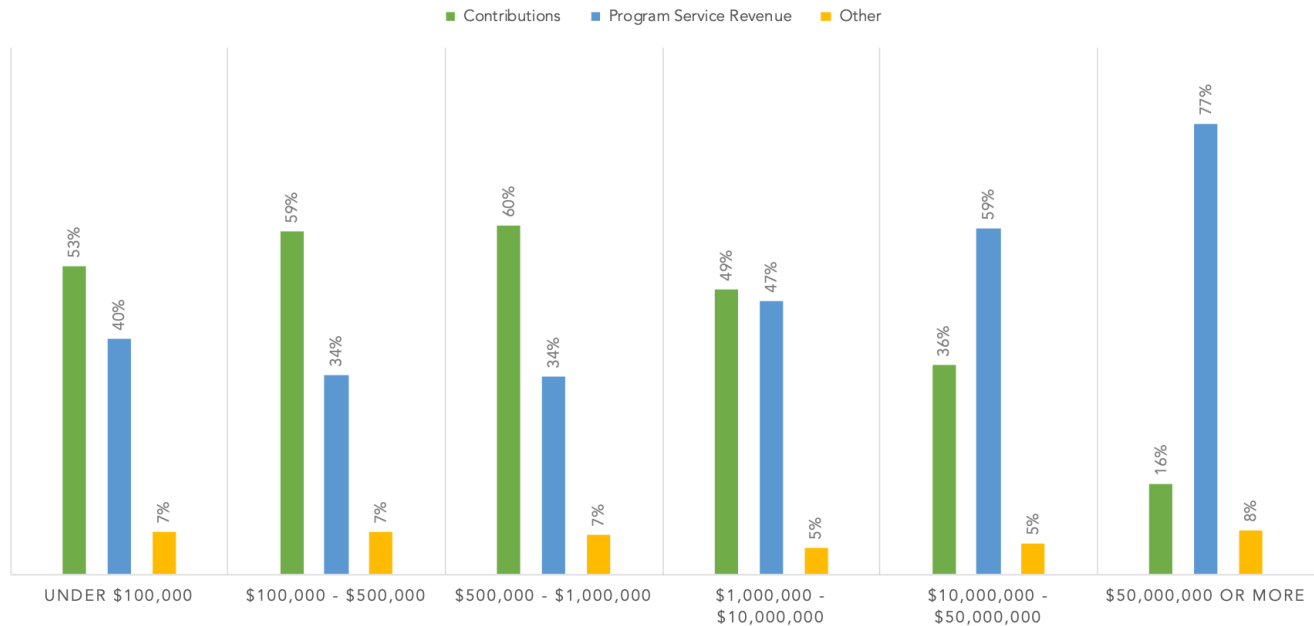


Source: Urban Institute, National Center for Charitable Statistics, Core Files (Public Charities, 2016).

Non-profits provide a staggering variety of services. Many of those services are not unlike governments – they conserve land for future generations, manage affordable housing programs, and provide pro bono legal services for people experiencing poverty. Like governments, a sizeable portion of their budget is spent on employee wages and benefits. And like governments, the sector is comprised of thousands of small organizations but dominated by a handful of larger organizations.

However, unlike governments, contributions are the primary source of revenues for most non-profits. Recall from our earlier discussion: public charities reporting expenses of less than \$1 million were three-quarters of the sector. The chart below shows that contributions were a significant revenue source, particularly for non-profits reporting \$1 million or less in expenses. Those reporting revenues of more than \$10 million were less reliant on contributions and more reliant on program service revenues, including tuition payments to revenues from sales of specialty goods, memberships, and patient revenues (including Medicare/Medicaid). Many remain skeptical that these large non-profits need or deserve tax exemption.

Public Charities Revenues by Source and Size, 2016



Source: Internal Revenue Service Statistical Tables (2017)

Federal, state, and local governments are an essential source of revenue for the sector. More than one-third of non-profit revenue is directly connected with the government – either as a grant, contract for services, or reimbursement for services provided (e.g., Medicaid/Medicare).

Government revenues are not distributed evenly, with significant variation based on sector and the size of the organization. This suggests that many non-profits are not necessarily independent entities with their own mission and organizational capacity but rather low-priced government contracts. In later chapters, we explore the advantages, disadvantages, and criticisms of this part of the non-profit-government nexus.

Governments also support the non-profit sector through a powerful tax preference. The federal government and most state governments offer a tax deduction for charitable giving. Donors give to non-profits for many reasons. Perhaps they like a non-profit's mission or strategy. Maybe they or someone they know received that organization's services. Or perhaps the decision to give had a lot to do with tax planning. When a donor gives to a non-profit, that donor's taxable income is reduced by the amount of that gift, so, for many individuals and corporations, in addition to supporting their favorite non-profit, charitable giving can also reduce their income tax liability, sometimes by up to 50 percent. The U.S. Congress' Joint Committee on Taxation estimates that the federal government's charitable deduction costs about \$50 billion annually in foregone revenue.

There is considerable controversy around the charitable deduction. Some believe it only benefits the wealthy and does little to encourage giving. Critics argue that big philanthropy, more than ordinary small donations, is wealth-derived power with minimal democratic controls and civic obligations (Rob Reich (2019) *Just Giving*). Philanthropy perpetuates vast differences in privilege and then tasks the privileged with improving the system (Darren Walker (2015) *Toward a New Gospel of Wealth*). Perhaps we should stop being grateful for philanthropy and instead direct our skepticism at their activities.

NON-PROFIT PILOTS – PAYMENTS IN LIEU OF TAXES

In every state, charitable non-profit organizations, including private universities, hospitals, museums, and churches, are exempt from property taxes. The impact of the property tax exemption largely depends on the degree of reliance on property taxes as a revenue source and real estate holdings of charitable organizations in the jurisdiction.

Yale University, for example, is New Haven's largest employer. The university's real estate holdings, including academic buildings, student housing, research facilities, and a sprawling hospital complex – are all property tax-exempt. In fact, 56 percent of New Haven's taxable property tax base is exempt. Yale owns a significant proportion of the exempt property.

Cities like Boston, Philadelphia, Pittsburgh, and Los Angeles face the same challenge. Their largest employers include private universities, non-profit hospitals, and cultural organizations, all of whom own valuable real estate – all of which is tax-exempt. While these organizations are economic engines for these cities, the growth in commercial activities by non-profit organizations has raised questions about their property tax exemption. More importantly, the substantial reduction in the taxable base has led to higher property tax rates for residents.

PILOTs (or payments in lieu of taxes) are payments made by tax-exempt non-profit organizations in place of property taxes. PILOT payments are structured as either one-time or long-term contracts with annual payments at a fraction of the locality's foregone property tax revenue.

PILOTs are often the result of tense negotiations. Consider the case of the City of Pittsburgh and the University of Pittsburgh Medical Center. In 2013, the city sued the UPMC. The goal of the lawsuit was to strip UPMC of its tax-exempt status. According to the City's complaint, UPMC did not deliver adequate charity care to justify its tax-exempt status, made no payments in lieu of taxes, and paid its executives lavish compensation packages. Had the City won in court, it planned to impose a 0.55 percent income tax on wages earned by UPMC employees. UPMC counter-sued, claiming it had been unfairly singled out among Pittsburgh's dozens of large tax-exempt organizations. The city dropped its suit in July 2014.

Source: J. Brian Charles (2018) "Towns Gowns and Real Estate" *Governing Magazine* and Daphne Kenyon and Adam Langley (2010) "Payments in Lieu of taxes: Balancing Municipal and Non-profit Interests" Lincoln Institute of Land Policy.

THE BASIC FINANCIAL STATEMENTS

FINANCIAL STATEMENTS: THE “FINANCIAL STORY”

Financial statements help managers answer a variety of questions:

- What and how much does the organization own? What and how much does it owe? Does this organization have enough financial resources to cover its obligations as they come due?
- What are the major sources of revenue for this organization? What are its spending priorities? Do the organization’s sources of revenue and spending priorities reflect the organization’s core mission?
- How much of this organization’s spending does it control? How much of its spending is directed by outside stakeholders like donors, clients, residents, or investors?
- How much, if any, does this organization report in “reserves” or its “rainy day fund”? Given its operations, what would be the optimal level of reserves?

In November 2013, the Contra Costa County (California) Board of Supervisors voted to end nearly \$2 million in contracts with the non-profit Mental Health Consumer Concerns (MHCC). The reason: MHCC’s savings account had grown too large.

Since the late 1970s, MHCC has offered patient rights advocacy, life skills coaching, anger management classes, and several other mental health-related services to its poorest residents of the Bay Area. Much of its work was funded through contracts with local governments.

In 2007, its Board of Trustees began to divert 10-15 percent of all money received on every government contract to a reserve account (or rainy-day fund). MHCC’s management concluded that this policy was necessary after several governments were consistently late on their payments. MHCC’s plan was designed to guarantee that the organization would not be exposed to unpredictable cash inflows. The board and management considered this a prudent use of public dollars and a necessary step to protect the organization’s financial future. Beginning in 2007 through 2011, nearly \$400,000 flowed into the new rainy-day fund.

Contra Costa County disagreed. They interpreted the contracts to mean reimbursements were only for actual service delivery expenses. They also pointed out that those contracts prohibited carrying over funds from year to year. A reserve fund containing County funds was, therefore, a violation of those contracts. MHCC pointed out that they disclosed the reserve fund strategy in their annual financial reports. The reserve allowed them to deliver services uninterrupted, even during the worst moments of the Great Recession. Contra Costa County Supervisor Karen Mitchoff responded by

saying MHCC's financial statements were not the appropriate channel to communicate such a contentious policy choice. She added, "I am not sympathetic to the establishment of the reserve, and the non-profit board knows they had a fiduciary responsibility to be on top of this."

The contracts were canceled, and MHCC dissolved in early 2011.

This episode illustrates two of the key takeaways from this chapter. First, an organization's financial statements are a vital communication tool. They tell us about its mission, priorities, and service delivery strategy. In this case, MHCC made a policy decision to deliver less service in the near term in exchange for the ability to deliver more consistent and predictable services in the future. That choice is reflected in MHCC's financial statements (e.g., assets exceed liabilities, and unrestricted net assets were a significant proportion of net assets). MHCC disclosed the rainy-day fund policy in the notes to its financial statements. Second, and more importantly, financial statements are only useful if the audience knows how to read them. In this case, Contra Costa County failed to understand how the rainy-day fund policy was communicated in the financial statements and how it affected MHCC's finances and its ability to accomplish its mission. Without the ability or desire to interpret the financial statements, the County considered MHCC's actions a breach of contract. Whether a rainy-day fund is, a direct service expense is an important policy question. So is the question of if and how a government should use financial statements for oversight of its non-profit contractors. But to engage these and many other questions, one must first understand how a public organization's financial statements tell its "financial story."

LEARNING OBJECTIVES

After reading this chapter, you should be able to:

- Identify the fundamental equation of accounting.
- Identify the basic financial statements: balance sheet, income statement, and cash flow statements.
- Recognize key elements in every financial statement, including assets, liabilities, revenues, expenses, change in net assets, change in net position, and change in fund balance.
- Understand what information each statement is designed to convey about an organization.

BUDGETING VS. ACCOUNTING

If you want to know how an organization connects its money to its mission, read its budget. If the budget calls for more spending in one program and less in another, that tells us a lot about that organization's priorities. If one of its programs operates at a loss – but another program's profits subsidize that loss – that is also a clear statement about how that organization carries out its mission. We can think of many other ways an organization's money does or does not connect to its mission. A public organization's budget lays out the many unique ways it makes those connections.

But sometimes, we want an "apples-to-apples" comparison. Sometimes we want to know to what extent an organization's mission-money nexus is the same or different from similar organizations. Sometimes we want to know how efficiently an organization accomplishes its mission compared to

its peers. Sometimes we want to know if an organization is in comparatively good or bad financial health. To answer these types of questions, you need information found only in financial statements. In this chapter, we walk through the basic financial statements and the essential concepts from accounting you need to understand in order to interpret the information presented in those statements.

We may need to compare an organization's finances to the finances of other organizations. If our organization's expenses exceeded revenues, we might consider that to be a failure – unless, of course, we see organizations like it face similar challenges. If it failed to invest in its capital equipment, we might think it was neglecting its service delivery capacity – unless we saw other organizations make that same trade-off. These comparisons demand financial information based on standardized financial information from a broadly shared set of assumptions. As you'll see in Chapters 5 and 6, budgets rarely present information in a standard format.

Fortunately, we can get that information from an organization's financial statements. Financial statements are the main “output” or “deliverable” from the organization's accounting function. **Accounting is the process of recording, classifying, and summarizing economic events in a process that leads to the preparation of financial statements.** Unlike budgets, the numbers reported in financial statements are based on *generally accepted accounting principles (GAAP)* that prescribe when and how an organization should acknowledge economic activity.

GAAP tells us when an organization can say it *owns* an asset or *earned* revenue for delivering a service. These are known as principles of accounting recognition. The key point is that GAAP is a shared set of “rules of the game” for summarizing and reporting an organization's financial activities. If an organization offers GAAP-compliant financial information, we can compare its finances to itself over time and to other organizations.

Standardized rules are not the only difference between budgeting and accounting. Broadly speaking, if budgeting is the story, then accounting is the scorecard. An organization's budget tells us the activities it wants to do, how it plans to pay for those activities, and what it hopes to achieve. Politicians and non-profit board members love to talk about budgets because budgets are full of aspirations. Budgets are how leaders translate their dreams for the organization into a compelling story about what might happen.

Financial statements tell us what happened. Did the organization's revenues exceed its expenses? Did it pay for goods and services it received with cash or *on credit*? Did its investments gain value or lose value? How much revenue would it need to pay for capital improvements and equipment? Accountants often see themselves as the enforcers of accountability. That is why budget-makers and accountants often don't see eye-to-eye.

These two worldviews are different in many other important ways. As mentioned, budgeting is prospective (i.e., about the future), whereas accounting is retrospective (i.e., focused on the past). Budgets are designed primarily for an internal audience – elected officials, board members, department heads, program managers, etc. In contrast, accounting procedures produce financial reports mostly for an external audience, including taxpayers, investors, regulators, and funders. Budgeting focuses on resources that flow in and out of an organization, also known as the *financial*

resources focus. Accounting focuses on the long-term resources the organization controls and its long-term spending commitments, also known as the *economic resources focus*. In preparing a budget, the focus is on revenues and spending. In accounting, the focus is on assets and any claims against those assets. We present a summary of these perspectives in the table below.

How's Budgeting Different from Accounting?		
Characteristic	Budgeting	Accounting
Metaphor	<i>"The Story"</i>	<i>"The Scorecard"</i>
Viewpoint	<i>Prospective</i>	<i>Retrospective</i>
Format	<i>Idiosyncratic/Customized</i>	<i>Standardized</i>
Audience	<i>Internal</i>	<i>External</i>
Focus of Analysis	<i>Inputs/Outcomes</i>	<i>Solvency/Financial Health</i>
Organizing Equation	<i>Planned Revenues = Planned Spending</i>	<i>Assets = Liabilities + Net Assets</i>
Measurement Focus	<i>Financial Resources</i>	<i>Economic Resources</i>
Cost Measurement	<i>Market Price</i>	<i>Historical Cost</i>

WHO MAKES ACCOUNTING STANDARDS?

The Financial Accounting Standards Board (FASB) produces GAAP for publicly traded companies and non-profits. The Governmental Accounting Standards Board (GASB) produces GAAP for state and local governments. Both the FASB and the GASB are governed by the Financial Accounting Federation (FAF), a non-profit organization headquartered in Norwalk, CT, just outside of New York City. Both Boards are comprised of experts from their respective groups of stakeholders: accounting, auditing, "preparers" (entities that prepare financial statements, like companies and governments), and academia. The Securities and Exchange Commission (SEC), the federal government agency that regulates public companies, designates the FASB as the official source of GAAP for public companies. The GASB has not been designated as such. Still, it is the de facto source of GAAP for governments because key stakeholders like municipal bondholders and credit ratings agencies have endorsed its standards. GAAP for federal government entities is produced by the Federal Accounting Standards Advisory Board (FASAB). The FASAB is comprised of accountants and auditors from federal government agencies. Federal government GAAP is still an emerging set of concepts and practices.

THE FUNDAMENTAL EQUATION OF ACCOUNTING

Everything we do in accounting is organized around the *fundamental accounting equation*. That equation is

$$\text{Assets} = \text{Liabilities} + \text{Net Assets}$$

An **asset** is anything of value that the organization owns. There are two types of assets: 1) short-term assets, known more generally as *current assets*, and 2) *long-term* or *non-current assets*. A current asset is any asset that the organization will likely sell, use, or convert to cash within a year.

When someone outside the organization owes money, and the organization expects to collect that

money within the year, that obligation is known as a receivable. If it's due within the year, it is classified as a current asset. An organization recognizes an *account receivable* or *A/R* when it delivers a service to a client and that client or customer agrees to pay within the current fiscal year. Non-profits frequently report *donations receivable* or *pledges receivable*. Pledges receivable represent a donor's commitment to give at a future date. The same logic applies to *grants receivable* when foundations or governments commit to giving the organization a grant. Governments recognize an overdue tax payment as *taxes receivable*. *Due from other governmental units* represents payments due to a government from other governmental units.

Organizations will report *inventory* or *supplies* if they expect to use these resources as they carry out routine operations. These are also current assets.

Most public organizations own buildings, vehicles, equipment, and other assets they use to deliver their services. These are *long-term assets*, as the organization expects to use them over multiple years (frequently referred to as *useful life*). Organizations are not likely to sell these assets, as doing so would diminish their capacity to deliver services. State and local governments build and maintain roads, bridges, sewer systems, and other *infrastructure assets*. These are among the most expensive and essential long-term assets in the public sector.

By contrast, a *liability* is anything the organization owes to others. To put it in more favorable terms, liabilities are how an organization acquires its assets. Here the short-term (or current) vs. long-term distinction also applies. *Current liabilities* are liabilities that the organization expects to pay within the next fiscal year. The most common are *accounts payable* for goods or services the organization has received but not yet paid for and *wages payable* for services delivered by employees but not yet paid for.

Long-term liabilities are money the organization will pay at some point beyond the current fiscal year. When an organization borrows money and agrees to pay it back over several years, it recognizes a *loan payable* or *bonds payable*. Many public sector employees earn a *pension* while they work for the government, and they expect to collect that pension once they retire. If the government has not set aside enough money to cover those future pension payments, it must report a *pension liability* (sometimes referenced as net pension liability).

What's left is called *net assets*. Technically speaking, net assets represent the difference between assets and liabilities. For private sector entities, this difference is known as the *owner's equity*. Public organizations do not have "owners." Instead, they have *stakeholders*, or anyone interested, financial or otherwise, in how well the organization achieves its mission. For governments, taxpayers are a rough analog to owners. But unlike shareholders, taxpayers do not have a legal claim to the government's assets. Their priorities also differ. Taxpayers want to see their governments deliver the services.

Similarly, donors expect contributions to be used to provide services. They do not expect to get their money back if the organization fails. However, they care about the organization's financial position and frequently focus on whether its operations are sustainable and will continue serving the public for generations to come. For these reasons, net assets are an important part of government and non-profit finances, but they do not have quite the same meaning as owners' equity for a for-profit entity.

That said, irrespective of sector, we should think of net assets as an indicator of the organization's financial strength. If its net assets are growing, that suggests its assets are growing faster than its liabilities, and in turn, so is its capacity to deliver services. If its net assets are shrinking, its service-delivery capacity is also shrinking.

We also have to think about the restrictions on net assets. The new accounting rules require non-profits to report net assets “*without donor restrictions*” and net assets “*with donor restrictions*.” Prior to FASB Accounting Standards Update 2016-14, net assets reported as *unrestricted* are now reported as net assets without donor restrictions. Net assets reported as *temporarily restricted* (i.e., net assets with time or use restrictions) or *permanently restricted* (i.e., net assets with restrictions that do not expire) are now reported as net assets with donor restrictions. While ASU 2016-14 is a significant change in how non-profits present financial information in their audited financial statements, how they account for these resources in day-to-day operations remains unchanged. Put differently, changes in GAAP do not alter or amend donor intent. Non-profits will need to continue to track gifts – but report in the financial statements in aggregated categories.

Governments use separate classification schemes, but these are a bit more detailed. We describe that scheme later in this chapter.

OWNERS = EQUITY HOLDERS

In for-profit organizations, the fundamental equation is **Assets = Liabilities + Owners' Equity**. Conceptually, every shareholder has a claim to assets that do not have an offsetting liability. Put differently, shareholders have a claim to all assets not otherwise promised to creditors or suppliers. When you buy a for-profit company's stock (or “shares”), you are, in effect, purchasing a portion of that company's owner's equity. That's why stocks are also known as equities. If a company's assets grow faster than its liabilities, its equity will become more valuable, and the price of its stock will increase, meaning investors who hold that stock make money. If, for example, you had invested in Apple stocks before the first iPod came to market in 2001, as of June 30, 2023, your portfolio's value would have increased by 58,679 percent (from \$0.33 per share to \$193.97 per share). The price of Apple shares reflects growth in revenues and, correspondingly, growth in assets.

THE BASIC FINANCIAL STATEMENTS

Organizations that follow GAAP produce three *basic financial statements*:

1. A **Balance Sheet** summarizes the organization's assets, liabilities, and net assets at the end of the fiscal period (e.g., as of December 31, 20XX).
2. An **Income Statement** presents a summary of the organization's revenues, expenses, and changes in net assets for the fiscal year (e.g., for the year ending December 31, 20XX).
3. A **Cash Flow Statement** shows how the organization receives and uses cash to carry out its mission (e.g., for the year ending December 31, 20XX).

In the discussion that follows, you will see more detail about each statement and how the information it contains can inform key management and policy decisions.

When considering an organization’s financial statements, keep one central point in mind: **Net assets are the focal point.** Regardless of the organization’s structure or mission or changes in assets, liabilities, revenues, expenses, and cash flows will affect net assets. While the content of each financial statement differs, the focus is on net assets.

Additionally, each statement’s presentation style and terminology vary depending on the sector. The table below summarizes these differences.

Statement	What For-Profits Call It	What Non-Profits Call it	What Governments Call It		
			Government-Wide Statements	Governmental Fund Financial Statements	Proprietary Fund Financial Statements
<i>Balance Sheet</i>	Balance Sheet or Statement of Financial Position	Statement of Financial Position	Statement of Net Position	Balance Sheet	Statement of Net Position
<i>Income Statement</i>	Income Statement, Profit & Loss (P&L) Statement, or Operating Statement	Statement of Activities	Statement of Activities	Statement of Revenues, Expenditures, and Changes in Fund Balances	Statement of Revenues, Expenses, and Changes in Net Position
<i>Cash Flow Statement</i>	Cash Flow Statement or Statement of Cash Flows	Statement of Cash Flows	N/A	N/A	Statement of Cash Flows

Many of the labeling differences are intended to contrast the mission orientation of non-profits and governments with the profit orientation of for-profits. We see this most clearly in the income statement. For-profit organizations often refer to the income statement as the “profit/loss statement,” given that its purpose is to distinguish its profitable products and services from its non-profitable products and services. For governments and non-profits, the focus is on “activities.” The question here is not whether the organization’s activities are profitable but how those activities advance its mission. **To be sustainable, every organization must generate more income than it incurs in expenses.** That said, profitability is not a primary objective for public sector organizations, as it is in the private sector.

You will also note several differences in what governments call these statements. We have already discussed how financial statements illuminate operational accountability or how efficiently and effectively an organization uses financial resources to advance its mission. Taxpayers want to know that their government delivers services efficiently and effectively. To that end, state and local governments prepare “government-wide” financial statements. These statements present the government’s overall financial position. These statements offer some insights into the government’s ability to continue to deliver services in the future. With a few modifications, these government-wide statements are conceptually like the basic financial statements for a non-profit or for-profit.

The government-wide balance sheet is called the *Statement of Net Position*, and the government-wide income statement is called the *Statement of Activities*. By referring to the income statement as the *Statement of Activities*, standard setters have sent a clear message: governments exist not to generate income but to produce activities. This also explains why there is no government-wide cash flow statement. Information about how a government generates and uses cash does not necessarily help us understand if it is achieving its mission.

But with governments, operational accountability is only part of the story. Taxpayers also want to know if their government did what they told it to do. They want to know if services were delivered with revenues collected. That's *fiscal accountability*.

When we think of fiscal accountability in government, we usually think of the budget. A **government's budget is not just a plan – it is the law**. Most governments' constitutions or charters require them to lay out their planned revenues and spending in a special law called an *appropriations ordinance*. They must pass legislation that makes their budget intentions clear. If they spend more than their budget allows or if monies are spent in ways not specified in their budget ordinance, they are breaking the law.

Budgets are enshrined in law because they are one of our most effective tools to ensure inter-period equity. *Inter-period equity* is the idea that if a government presents and approves a balanced budget, it is living within its means and not passing costs onto future generations.

Fiscal accountability and inter-period equity are so important that they are built not just into a government's budget but also its financial statements. For instance, imagine a school district levies a property tax to pay for school buildings. Taxpayers want to see how much revenue that tax generated, how much money the school district borrowed for capital improvements, how much of that revenue is being used to repay those borrowed funds, and so on. They want fiscal accountability on that special tax. To assess this, taxpayers need to see those revenues, expenditures, assets, and liabilities presented separately from all other operations. To do that, the school district must present those finances in a stand-alone *special revenue fund*.

A *fund* is a stand-alone, self-balancing set of accounts with a specific purpose. The *General Fund* has every government account for services paid for through general revenue sources. It is where local governments account for police, fire, public health, and other essential services paid for using locally adopted property and sales taxes. It is where state governments account for funding for education (K-12, public universities, and community colleges), public health, public safety, and other essential services paid for using state-wide income and sales tax revenues. For most governments, the General Fund is the largest and most carefully watched. According to GAAP, a government's General Fund, special revenue funds, *debt service funds*, *capital projects funds*, and *permanent funds* are collectively called *governmental funds*. The governmental funds account for the government's core operations and services.

Like budgets, governmental funds focus on near-term revenues and spending (also known as current financial measurement focus). For that reason, the information you see in governmental funds statements is prepared using a different set of accounting principles. Those principles are known as *modified accrual accounting* (or "fund accounting"). Modified accrual basis of accounting measures the current financial resources available. To that end, revenues are recognized when they are both *measurable* (i.e., revenues can reasonably be estimated) and *available* (i.e., revenues are available within 60 days). Expenditures are recognized when the costs have been incurred to acquire goods or services in the current period.

Funds are so important to governments that governments are required to present a separate set of fund financial statements prepared using the modified accrual basis of accounting. The balance sheet

in the governmental funds is called the *Balance Sheet*, and the income statement is called the *Statement of Revenues, Expenditures, and Changes in Fund Balance*.

Governments also deliver goods and services whose operations are similar to what we would find in the private sector. Examples include water and electric utilities, golf courses, swimming pools, and waste disposal facilities, to name a few. These are known as *business-type* or *proprietary activities*. In concept, business-type activities should cover their expenses with the revenue they generate through charges for services. Many governments operate business-type activities because they are profitable and can subsidize other services that cannot pay for themselves. Since business-type activities pay for themselves, we account for them on an *accrual basis* and prepare a separate set of fund statements referred to as *proprietary fund statements*. Accrual basis of accounting reports on a transaction when it has an economic impact, regardless of whether it spends or receives cash. Governments reporting business-type activities will prepare a *Statement of Net Position, Statement of Revenues, Expenses, and Changes in Net Position*, and a *Statement of Cash Flows* in the proprietary fund statements.

WHAT IS AN AUDIT REPORT?

You will find an audit report at the beginning of every set of financial statements. The report, formatted as a letter prepared by an external financial auditor, is presented to the organization's board and management and incorporated in the audited financial statements. The auditor performs a series of tests to assess the strength of internal controls (i.e., rules and procedures adopted by an organization to prevent fraud and abuse) and reviews a representative sample of transactions. Their work is designed to answer a simple question: Are the organization's financial statements a fair presentation of its actual financial position? Usually, the audit report expresses an unqualified opinion, meaning the auditor believes the financial statements are a fair presentation of the organization's financial position, operations, and cash flows. An unqualified audit report will contain language to the effect of "...these financial statements present, fairly, and in all material respects, this organization's financial position." If the auditor has reason to believe the financial statements do not present that position fairly, they will issue a qualified opinion or, in rare cases, an adverse opinion or disclaimer of opinion.

BASIC FINANCIAL STATEMENTS – NON-PROFIT ORGANIZATIONS

The basic financial statements of non-profit organizations include the *Statement of Financial Position, Statement of Activities, Statement of Cash Flows*, and *Statement of Functional Expenses*. Below is a quick review of each statement.

THE STATEMENT OF FINANCIAL POSITION

The *Statement of Financial Position*, the non-profit's balance sheet, is designed to answer a simple question: What is this organization's *financial position*? Financial position has both short-term and long-term components. If current assets exceed current liabilities, then the organization's short-term financial position is favorable. If long-term (i.e., non-current) assets exceed long-term liabilities, the organization is in a favorable long-term financial position. As you will see in the discussion that follows, an organization could be in a favorable long-term financial position but have a weak short-term financial position, and vice versa.

For that reason, a point of emphasis for the balance sheet is the relationship between the

organization's assets and liabilities. An organization's net position improves if its assets grow faster than its liabilities. If an organization's assets decrease or liabilities increase, its net position will deteriorate. We are always mindful of why an organization's net position has declined over time. Is that because the organization drew down on its reserves during a recession, or do changes reflect a loss in value in the non-profit's investments? The balance sheet offers a lot of this sort of detail. It also helps organizations formulate strategies to address the issues at hand. If the organization had to draw down on its reserves because of a deficit, it would need to budget for a surplus to replenish reserves. If the organization reported investment losses because of changes in the financial markets, it might opt to do nothing. Doing nothing is a strategy. We've seen the markets recover following a recession, including the Great Recession and the COVID-19 recession.

We provide a review of financial health measures, also known as *financial statement ratios*, that can help you answer some of these questions. Below are some questions you should ask when looking at an organization's balance sheet:

1. Do its total assets exceed its total liabilities? If they do, that is an indicator that the organization's long-term financial position is favorable.
2. Do its current assets exceed its current liabilities? If they do, that is an indicator that the organization's strong short-term financial position, sometimes referred to as *working capital*, is favorable.
3. Of total assets, what proportion are current assets? What proportion are fixed assets (i.e., buildings and equipment)? What proportion are restricted investments? Buildings and equipment add to operating costs (i.e., maintenance and operating costs). Investments, including restricted (or endowment) investments, are a real source of income, and unrestricted investments may be used to support the organization's operations.
4. Of current assets, what proportion are receivables? What proportion of receivables is due in 12 months or less? What proportion of receivables due is from a single donor or grantor? The concentration of receivables with an individual donor is a source of financial uncertainty.
5. What proportion of assets is in the form of cash and cash equivalents? What proportion of current assets is in the form of cash and cash equivalents? How much cash does the organization have relative to its current liabilities? We often hear the phrase **cash is king**. Cash is a liquid asset that allows the organization to meet its obligations as they come due and provides it with the opportunity to invest in new opportunities or immediately respond to a crisis. At the same time, an organization can have too much cash. If it has more cash than it needs to cover its day-to-day operations, it could invest some of that idle cash in marketable securities or other safe investments and earn a nominal return.
6. What proportion of net assets is without donor restrictions? What proportion of net assets is with donor restrictions? Net assets without donor restrictions can be used to cover short-term spending needs, while net assets with donor restrictions cannot, as doing so would violate donor intent.
7. Does the organization have non-current liabilities? How might these affect the organization's current assets in the future? Long-term liabilities like loans, bonds, legal settlements, and pension liabilities increase demand for cash.

It is essential to keep in mind that the **balance sheet is a snapshot in time**. When an organization's accounting staff prepares the balance sheet, they present balances in every account on a particular day, usually the last day of the fiscal year. If an organization has a dynamic balance sheet, its financial position could look quite different from one week to the next or one month to the next based on activities in key balance sheet accounts (e.g., cash, accounts receivable, and investments).

Let's look at an example. The *Statement of Financial Position* for Treehouse for the year ending June 30, 2022, is below. The financial statements include consolidated accounts of Treehouse and 2100 LLC (i.e., Treehouse's interest in the 2100 Building) in FY 2022. Treehouse did not include FY 2021 information in its financial statements at the end of FY 2022. That information is presented here for comparison purposes only.

Treehouse
Consolidated Statement of Financial Position

ASSETS	FY 2022	FY 2021
CURRENT ASSETS		
Cash and cash equivalents	\$ 4,430,208	\$ 5,552,763
Investments	3,162,683	4,144,242
Current pledges receivable, net	970,433	35,000
Contributions receivable (rent), net	195,182	582,099
Contracts receivable	3,528,538	1,141,268
Inventories	315,985	393,462
Unemployment trust deposits	128,572	302,309
Prepaid expenses	364,127	46,213
Total Current Assets	13,095,728	12,197,356
LONG-TERM ASSETS		
Long-term portion of pledges receivable, net	355,448	1,308,470
Property and equipment, net	1,228,420	1,227,762
Interest in 2100 Building	7,097,000	
Endowment investments	5,189,663	6,373,414
Total Long-Term Assets	13,870,531	8,909,646
Total Assets	26,966,259	21,107,002
CURRENT LIABILITIES		
Accounts payable	\$ 143,584	\$ 286,030
Other Liabilities	266,444	-
Accrued salaries and related costs	829,883	716,656
Total Current Liabilities	1,239,911	1,002,686
NET ASSETS		
Without donor restrictions	\$ 19,743,171	\$ 12,564,684
With donor restrictions	5,983,177	7,539,632
Total Net Assets	25,726,348	20,104,316
Total Liabilities and Net Assets	26,966,259	21,107,002

Download Treehouse Financials: <https://bit.ly/3OTmpO7>

Every balance sheet will begin with a summary of assets first. Assets are listed in *reducing order of liquidity*. What that means is that the most liquid asset appears first, and the least liquid assets appear near the bottom. We can convert an asset to cash by selling it or, in the case of receivables, collecting it. Cash is, of course, the most liquid asset. That is why it is listed first. Cash equivalents (including *commercial paper* and *marketable securities* like *money market mutual funds* and *overnight*

repurchase agreements or “Repos”) are safe short-term investments that can be converted to cash immediately at low or no cost. Receivables will convert into cash as clients and donors make payments. Current assets that we do not expect to convert to cash quickly are listed below cash and receivables. Restricted assets are not considered liquid and are reported below the least liquid current asset (e.g., inventory or pre-paid expenses) or are not reported as current assets (e.g., endowment investments).

Treehouse reports the most typical current assets:

- *Investments* include holdings of stocks, bonds, and other conventional financial instruments, including investments in mutual funds. Note that investments are reported separately from Endowment Investments (non-current), as the latter is subject to internal (board-designated) and external (donor-imposed) restrictions. Note that investments are reported separately from cash equivalents, as they are bought and sold less frequently. This, however, should not be confused with liquidity. A vast majority of financial investments are liquid. However, unlike cash equivalents, investments do not mature every 30 days or every three months; as a result, they need not be actively traded.
- *Receivables* refer to money owed to the organization. When customers pay money owed to the organization, that asset converts to cash. Treehouse reports net receivables. This means it has subtracted from that receivables figure the portion of those receivables it has determined it cannot collect. Those removals are known as *an allowance for uncollectible or bad debt expenses*. The nonprofit reports pledges, rent, and contracts receivable separately. Pledges receivable represent a donor’s commitment to give at a future date. Rent receivable represents rent due from tenants in their building. Rent receivable is reported separately from contracts receivable to capture differences in the types of services provided.
- *Inventory* includes goods that the organization intends to sell or give away as part of delivering its services. Much of Treehouse’s inventory is in “The Treehouse Store,” a thrift store where children can pick up clothing and personal items for free. Many organizations (Treehouse not included) report a separate category for *supplies*. These are goods and materials, usually *commodities*, that the organization intends to use while delivering its services. Unlike marketable securities and investments, there may not be a robust market for supplies and inventory, so they are among the least liquid current assets.
- *Pre-paid expenses* are incurred when an organization opts to pay in advance for services (e.g., insurance, memberships, subscriptions) it will use later. If the organization cancels or renegotiates a pre-paid expense, a refund will be processed for the unused pre-paid amount. This is rare and is subject to contract restrictions.

Treehouse also reports the most common long-term assets. These are listed in decreasing order of liquidity:

- *Long-term receivables* are monies owed to the organization to be received over multiple financial periods. This is especially true for grants, contracts, and pledges that are not in the current period. These long-term receivables are also reported as net of allowance for uncollectable or bad debt expenses. Long-term receivables must also be discounted to present value using the prevailing market interest rate. Recall that present value is the amount of

money a future investment is worth today. Reporting long-term receivables in present value terms recognizes the foregone interest.

- Fixed assets are the least liquid, as the organization's ability to convert these assets into cash will incur costs and take time. *Property and equipment* are reported *book value* – that is, *historical cost* or purchase price, net of *depreciation*. Depreciation is the loss in value of an asset due to wear and tear. Effective December 2021, Treehouse became co-owner of its building when a portion of the property was donated to the organization. The Statement of Financial Position reports the fair market value of Treehouse's share of the building at the time of the donation. Going forward, the value of the organization's interest will be reported net of depreciation.

BOOK VALUE VS. MARKET VALUE

Accountants usually report assets at *historical cost* or the cost the organization paid to acquire them. For instance, if an organization purchased a building for \$500,000 10 years ago, it would report a book value equal to the historical cost net of depreciation. Meanwhile, an *appraiser* might estimate that a buyer would be willing to pay \$1,000,000 for that building today. This is the building's estimated *market value*. Accountants prefer historical costs. In fact, that preference is so strong that it is called the *historical cost rule* of accounting. Until that building is sold for \$1,000,000, that figure is just a guess that is too unreliable as a basis for financial reporting.

- *Endowment Investments* represent donor-restricted funds. For that reason, endowment investments are frequently listed as non-current assets. Note that investments remain liquid – the classification as a non-current asset reflects restrictions on use. Investment earnings could be invested in the programs or services if donor restrictions do not apply. Treehouse reports endowment investments separately from its other investments and cash holdings. Not all non-profits will report investments this way. That said, they must disclose the different types of endowment funds (or donor-restricted net assets) in the notes to the financial statements.
- *Other Investments*. Many investments are not liquid because their owner is not allowed to sell them. For example, venture capital funds, hedge funds, and private equity funds mandate lock-in periods. Investors trade off liquidity in these funds but expect higher investment returns. Some investments are less liquid because there are fewer potential buyers. Commercial real estate, for instance, can take some time to sell because there are fewer potential investors interested in those types of properties than in residential real estate. All these investments are reported as “other” long-term assets.

FAIR VALUE VS. HISTORICAL COST

Investments are a notable exception to the historical cost rule. Most investments trade on an exchange like the New York Stock Exchange. The prices quoted in those exchanges are a reasonable estimate of the value of a stock or bond. Since we can readily observe that the fair market value or the value of the investment can be objectively obtained, we replace the historical cost with a fair value estimate. Assuming a non-profit purchased 1,000 shares of Apple stock in 2001 for \$0.33 per share, the value of that portfolio, as of June 30, 2023, would have been \$193,970. We adjust our books on an annual basis to recognize the gains or losses in the value of our investments. In this case, we would report the change in the investment value as the price of Apple stock increased by \$55.86 from \$138.11 on July 1, 2022, to \$193.97 on June 30, 2023. Despite the considerable gain in the value, accountants are comfortable relaxing the historical cost rule because we objectively measured the value of the Apple stock.

In every balance sheet, liabilities are listed in *increasing order of maturity*. Maturity refers to the moment in time when payment is due. Said differently, liabilities are listed based on how quickly the organization will need to pay them. Treehouse's balance sheet includes the two most common current liabilities: accounts payable and accrued salaries and related costs (i.e., wages payable). These are liabilities that will come due within the fiscal year. Like many non-profits, Treehouse does not report any long-term liabilities like a mortgage or a loan. If it had, it would list the proportion due in the next twelve months under current liabilities and the proportion due after that under non-current liabilities.

At a glance, three key features of Treehouse's balance sheet stand out. First, its current assets far exceed the non-profit's current liabilities. Its near-term financial position is robust, and the non-profit has more than enough cash to cover its obligations as they come due.

Every balance sheet will present a summary of the organization's net position (equity, net assets, net position, or fund balance). In the case of Treehouse, a non-profit, its net position is reported in one of two categories: net assets "*without donor restrictions*" or net assets "*with donor restrictions*." Net assets with restrictions include donor-restricted endowment funds (previously listed as permanently restricted) and contributions receivable that are restricted over time and/or use (previously listed as temporarily restricted). Board-designated quasi-endowment funds and accumulated profits are reported under net assets "*without donor restrictions*."

The balance sheet shows Treehouse is in a strong financial position, has the right balance across its current and long-term assets, and does not have any long-term liabilities. It also has greater autonomy over its financial resources, as 76 percent of its net assets are not subject to donor restrictions.

NOTES TO THE FINANCIAL STATEMENTS

GAAP imposes uniformity on how public organizations recognize and report their financial activity. But at the same time, all public organizations are a bit different. They have different missions, financial policies, tolerances for financial risk, and so forth. Moreover, large parts of GAAP afford organizations a lot of discretion on how and when to recognize certain types of transactions. For these reasons, numbers in the basic financial statements do not always tell the complete financial story about the organization in question. **That is why it is essential to read the “Notes to the Financial Statements.”** The notes are narrative explanations at the end of the financial statements. They outline the organization’s key accounting assumptions, share its key financial policies, and explain any unique transactions or other financial activity.

STATEMENT OF ACTIVITIES

The *Statement of Activities*, the non-profit’s income statement, is designed to tell us if an organization’s programs and services cover its costs. In other words, is this organization *profitable*?

Every income statement will begin with a summary of *revenues* and a report of *expenses*, either by program or line item. In GAAP, revenue is what the organization earns for delivering services or selling goods. Expenses are the cost of doing business. Whenever possible, think of expenses in terms of the revenues they help to generate. For non-profit organizations, this relationship is sometimes clear and sometimes not. For example, imagine that a non-profit conservation organization operates guided backpacking trips. Participants pay a small fee to participate in those trips. To run those trips, the organization will incur expenses like wages paid to the trip guides, supplies, costs related to state permits, and so forth. These are expenses incurred while producing backpacking tour revenue. Here the relationship between revenues and expenses is clear.

This same organization might sell coffee mugs, water bottles, and other merchandise and then use those revenues to support its conservation mission. The expenses to produce those mugs are known as the *cost of goods sold*. Here again, the revenue-expense relationship is clear. When that link is clear, we can determine if a program/service/product is *profitable*. That is, does the revenue it generates exceed the expenses it uses up?

In for-profit organizations, profitability and accountability are virtually synonymous. But for public organizations, profitability has little to do with accountability. For instance, our conservation non-profit might accept donations from individuals in support of its conservation work. Which expenses were necessary to “produce” those revenues? The development director’s salary? The administrator’s travel expenses to visit a key donor? The expenses from a recent marketing campaign? Here, the revenue-expense link is less clear. Same for in-kind contributions (i.e., donated goods and services) the organization receives in support of its mission. This link is even murkier for governments, where taxpayers pay income, property, and sales taxes. Those taxes have no direct link to the expenses the government incurs to deliver police, fire, parks, public health, and other services.

To put this in the language of accounting, public organizations have a mix of *exchange-like activities*, such as backpacking trips and coffee mugs, and *non-exchange-like activities*, like conservation programs and public safety functions that are just as, if not more, central to their mission as their

exchange-like activities. That is why profitability is one of the many criteria we need to apply when thinking about a public organization's finances.

That said, the main point of emphasis on the income statement is the relationship between revenues and expenses. As mentioned, net assets are a good indication of that relationship. If revenues increase faster than expenses, then net assets increase. If expenses increased faster than revenues, net assets would decrease. The income statement can help illuminate several follow-up questions to understand an organization's revenues-expenses relationship in some detail:

1. How much did net assets increase since last year? How much of that increase was in net assets without donor restrictions? How much was in net assets with donor restrictions? Growth in net assets without donor restrictions indicates that the organization's core programs and services are profitable. An increase in net assets with donor restrictions can mean many other things. It could mean the non-profit received additional donations that had a time or purpose restriction. The non-profit would need to meet those restrictions over multiple years. It could also mean the non-profit's endowment reported a positive return. That return may be reinvested in the endowment or diverted to cover core operational expenses.
2. What portion of revenue is from *earned income* versus *contributed income*? Earned revenue, or revenue generated when the organization sells goods or services, is attractive because managers have direct control of expenses needed to generate that income. Contributions are less predictable and less directly manageable but do not have an immediate offsetting expense – except for fundraising and development costs. That said, the disconnect between donor and beneficiary provides the non-profit with the ability to manage expenses given changes in contributions.
3. What percentage of earned revenue is from the organization's core programs and services? What proportion is from other activities and other lines of business (sometimes known as unrelated business income)? It is common for non-core programs and services to subsidize core programs and services, but is that the right policy for this organization to pursue? Non-profits that generate unrelated business income must pay UBIT – *unrelated business income tax* on profits earned from activities not substantially related to the charitable organization.
4. To what extent does this organization rely on in-kind contributions? Investment income? In-kind contributions will vary by type of organization. Food banks are more likely to report in-kind contributions as a major source of revenue. Treehouse received an in-kind donation of an interest in their building. Professionals in legal, marketing, and accounting service industries frequently provide local non-profits with services for free or at steep discounts. These are reported as in-kind donations.

How much the non-profit reports as investment income largely depends on the size of the investment portfolio. Foundations, for example, will report investment income as the single largest source of revenue. In contrast, for most non-profits, investment income makes up a smaller portion of overall revenues. Still, it often allows the organization to report a surplus at the end of the fiscal year.

To illustrate, let us examine Treehouse's Statement of Activities for the year ending June 30, 2022. The income statement reports revenues by source and by restriction and expenses by function (program,

management, or fundraising). While Treehouse does not report expenses for each program, a detailed list of expenses can be found in the *Statement of Functional Expenses*.

Treehouse
Consolidated Statement of Activities

	FY 2022			FY 2021		
	Without donor restrictions	With donor restrictions	Total	Without donor restrictions	With donor restrictions	Total
OPERATING REVENUE						
Contributions and grants	9,400,113	640,000	10,040,113	8,257,401	350,000	8,607,401
In-kind contributions	662,156	-	662,156	580,307	271,968	852,275
Contract revenue	12,659,996	-	12,659,996	3,867,313	-	3,867,313
SBA PPP Proceeds	-	-	-	-	-	-
Other Revenue	23,358	-	23,358	137,164	-	137,164
Net assets released from restrictions	1,270,202	(1,270,202)	-	878,350	(878,350)	-
Total Revenue	24,015,825	(630,202)	23,385,623	13,720,535	(256,382)	13,464,153
OPERATING EXPENSES						
Program services	19,577,929	-	19,577,929	8,129,972	-	8,129,972
Management and general	1,659,555	-	1,659,555	945,581	-	945,581
Fundraising	2,262,043	-	2,262,043	1,588,136	-	1,588,136
Total Expenses	23,499,527	-	23,499,527	10,663,689	-	10,663,689
CHANGES IN OPERATING NET ASSETS	516,298	(630,202)	(113,904)	3,056,846	(256,382)	2,800,464
NON-OPERATING ACTIVITY						
Investment Income (Loss)	(505,340)	(856,252)	(1,361,592)	127,859	1,246,119	1,373,978
Donation of interest in building	7,097,000	-	7,097,000	-	-	7,097,000
Property Related Revenues	123,011	-	123,011	-	-	123,011
Property Related Expenses	(122,486)	-	(122,486)	-	-	(122,486)
Total Non-Operating Activity	6,592,185	(856,252)	5,735,933	127,859	1,246,119	1,373,978
TOTAL CHANGE IN NET ASSETS	7,108,483	(1,486,454)	5,622,029	3,184,705	989,737	4,174,442
NET ASSETS, beginning of year	12,634,688	7,469,631	20,104,316	9,379,979	6,549,895	15,929,874
NET ASSETS, end of year	19,743,171	5,983,177	25,726,345	12,564,684	7,539,632	20,104,316

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For FY 2022, Treehouse reported \$23.4 million in revenues. Of that, \$10.04 million was from contributions and grants, \$0.7 million was from in-kind contributions, and \$12.7 million from contract revenue. Most of Treehouse’s income is not subject to donor restrictions (i.e., without donor restrictions). Investment income, classified as non-operating revenues, is reported separately from operating revenues (i.e., grants, contributions, and contract revenue). Investment income would be classified as operating revenue in instances where the non-profit has invested a substantial proportion of its resources to generate income to support core programs or cover overhead costs. That is not the case for Treehouse.

Net assets released from restrictions represent a reclassification of net assets. That reclassification will appear as a reduction in net assets “with donor restrictions” and a corresponding increase in net assets “without donor restrictions.” In doing so, the non-profit is reporting it has satisfied the intent of the donation or grant received in the current or prior period. Remember, restrictions only apply to revenues; they do not apply to expenses, hence the need to release assets from restrictions.

In the expense part of the Statement, we see that expenses for program services were \$19.6 million – approximately 83 percent of total expenses. Treehouse reports non-operating income separately from operating income, which indicates that income generated from investments and other sources was not derived from core activities. Not surprisingly, Treehouse reported investment losses at the end of FY 2022 (\$1.4 million). It also reported the in-kind donation of an interest in the building (\$7.1 million) as non-operating activity. In doing so, the organization conveys to stakeholders that it does not view this donation or related activities as part of its core operations.

Change in net assets is a focal point when reviewing the Statement of Activities. In FY 2022, Treehouse reported a positive change in net assets of \$5.6 million. Much of this can be attributed to the in-kind donation of interest in a building (\$7.1 million). Adjusting for the gift, Treehouse reported a deficit at the end of FY 2022. However, that deficit was primarily driven by investment losses – not the nonprofit’s core operations. Judging an organization’s performance using data from a single year is often difficult. Five years of data could provide a more compelling narrative of the organization’s financial position and operating results. More on this in Chapter 3.

WHAT IS THE OPTIMAL LEVEL OF RESERVES?

Well, as one of us likes to say, *it depends* on a wide variety of factors, including revenue mix and volatility, timing of cash flows, changes in demand for services – particularly in an economic downturn – existing capital investments, and the need for capital improvements, to name a few. **In creating reserves, a clear statement of purpose, size, and strategy to accumulate, expend, and replenish reserves should be discussed and adopted.**

The Non-profit Finance Fund (NFF, see <https://nff.org/fundamental/kinds-capital>) recommends that non-profits create and accumulate reserves with specific goals in mind. Categories include (a) *working capital reserves* to ensure timely payment of obligations as they come due, (b) *operating reserves* used to absorb unforeseen revenue losses or unexpected extraordinary expenses, (c) *risk and opportunity capital* to support program development and innovation, (d) *change capital* that helps the organization address strategic issues including social justice, changes in government policies, or existential threats to operations (e.g., disruptive technology), (e) *recovery capital* to help recover from damaging financial shortfalls, reduce debt, or fund much-needed repairs to facilities and equipment, (f) *facilities and equipment capital* that finances the purchase of capital equipment or upgrades to existing infrastructure, and (g) *endowments* that generate investment income that can be used to support core programs or replenish reserves. Organizations need not establish each reserve, and one could argue that the categories are fluid. For example, some could consider operating reserves the same as recovery capital. Others are not. For example, working capital reserves allow the organization to cover program costs while payments from funders are pending. Working capital reserves are essential to every organization and are not the same as operating reserves. Every organization needs a working capital reserve, but not all organizations need recovery capital; therefore, the context of operations and environmental factors matter in creating and drawing on reserves.

How do you build and replenish reserves? **Non-profits should budget for reserves.** To ensure they meet that goal, they should include budget reserves as a line item in their operating budget or intentionally budget for a surplus. Capital campaigns would raise funds to fund capital improvements or create endowments. However, doing so could divert donations from operating activities. For that reason, the use of capital campaigns to create reserves should be strategic. Governments adopt similar approaches to build and replenish their “rainy-day” or “budget-stabilization funds.” More on this in Chapter 6.

STATEMENT OF CASH FLOWS

The *Statement of Cash Flows* is just as the title suggests. It tells us how an organization receives and uses cash.

It might seem strange to devote an entire financial statement to a specific asset. But cash is not just any asset. **Cash is king!** For small organizations, especially small non-profits, it is possible to run out of cash. If that happens, nothing about that organization's mission, clients, or impact on society will matter. Its employees, vendors, and creditors will not take a compelling mission statement as a form of payment. If the organization is out of cash, it is out of business.

To that end, the Statement of Cash Flows is quite useful if we want to answer a few key questions about how a public organization receives and uses cash:

- a. Did the organization's core operations generate more cash than they used? If not, why?
- b. Did the organization depend on cash flow from investing or financing activities to support cash flows necessary for basic operations? How predictable are cash flows from investing and financing activities?
- c. How much of the organization's cash is the result of transactions it cannot directly control (e.g., receivables)?
- d. How much of the organization's cash flow is related to sales of goods and inventory? How predictable are those sales?

From the cash flow statement, we can learn a lot about the specific ways an organization generates and uses cash. The statement breaks cash flows into three categories: operations, investing activities, and financing activities. Euphemistically, we call this "OIF" (pronounced "oy-f"):

1. *Cash Flow from Operations* presents a summary of how the organization receives cash and uses cash for its core activities. Negative cash flow from operations indicates that the organization's basic operations use more cash than they produce. It could mean the organization reported profits because of growth in revenues – but those revenues remain uncollected and are reported as receivables. It could also be the case that the non-profit did not report a profit but reports positive cash flows from operations as a result of collecting outstanding receivables. While our discussion is focused on profitability, keep in mind that without positive cash flows from operations, the organization's finances are not sustainable.
2. *Cash Flow from Investing Activities*. In this case, investing includes investments in financial instruments or fixed assets like property and equipment. For most non-profits, this section is focused on cash earned from investments. If those investments produced more cash than what was spent to acquire them, they provide *positive cash flow*. Purchases of buildings and equipment are a *cash outflow*, and if the organization sells any buildings or equipment, the receipts from those sales also appear here as a cash inflow (though this is rare). In general, we expect positive cash flow from investing activities. It's essential, however, to know the origins of that positive cash flow. If the organization sold a building, that might produce positive cash flow, but at the expense of its ability to deliver services in the future. It might see negative cash flow from investing activities if, for instance, it moves idle cash into short-term investments.
3. *Cash Flow from Financing Activities*. Financing activities capture any cash the organization borrows to finance its operations. Most of the activity in this section has to do with borrowed money. For-profit entities use this section of the cash flow statement to show how issuing stock produces a cash inflow. For non-profits and governments, the cash inflow from issuing

bonds or taking out a loan will appear here. For non-profits with an *endowment* or other *permanently restricted net assets* that produce unrestricted investment income, that cash flow will also appear here.

Like with the balance sheet and income statement, net assets are a key part of most public organizations' cash flow statements, especially cash flows from operating activities. It might seem strange that net assets are the point of departure for a statement about cash, but it makes sense if we are willing to make a few assumptions.

Recall that the most common way for net assets to increase is for revenues to exceed expenses. To understand the cash flow statement, take this idea a step further. Assume that a public organization's total cash will increase during a fiscal period if the cash inflows from its main operating revenues exceed the cash it pays out to cover its main operating expenses. The "cash flow from operations" part of the cash flow statement is based on precisely this idea. It starts with the assumption that an organization's change in net assets is a good indicator of its cash flows from operations.

Treehouse
Consolidated Statement of Cash Flows
Year Ended June 30, 2022

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	\$ 5,622,029
Adjustments to reconcile change in net assets to net cash flows from operating activities	
Depreciation	286,275
Donated investments	(336,936)
Net realized and unrealized losses (gains) on investments	1,568,107
Changes in allowance and discounts on receivables	(24,422)
Donation of interest in building	(7,097,000)
Changes in operating assets and liabilities	
Pledges receivable	42,101
Contribution receivable for rent	386,917
Contracts & Other receivable	(2,387,270)
Inventories	77,477
Deposits held in trust	173,737
Prepaid expenses	(317,914)
Accounts payable	123,999
Accrued salaries and related costs	113,229
	113,229
Net cash used in operating activities	(1,769,671)
CASH FLOWS USED IN INVESTING ACTIVITIES	
Purchase of investments	(195,512)
Proceeds from sale of investments	1,129,561
Purchase of furniture and equipment	(286,933)
	(286,933)
Net cash from investing activities	647,116
NET CHANGE IN CASH AND CASH EQUIVALENTS	(1,122,555)
CASH AND CASH EQUIVALENTS, beginning of year	5,552,763
CASH AND CASH EQUIVALENTS, end of year	\$ 4,430,208

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Most sizable public organizations follow this concept and report their cash flows from operations using the *indirect method*. This method starts with the Change in Net Assets, assuming that change is the result of cash flows from operations. But of course, not all changes in net assets are the result of positive or negative cash flow. Different transactions and accounting procedures can affect revenues or expenses without affecting cash flow. A typical example is depreciation. Depreciation is when an organization “uses up” some portion of an asset to deliver services. The portion of that asset’s value that is used up is recorded as a depreciation expense. Like all expenses, depreciation reduces net assets. But at the same time, there is no cash flow associated with depreciation. You will not find checks written to an entity called “Depreciation.” The same is true for changes in the value of an

organization's investments. Its stocks, bonds, and other investments can increase in value, but unless it sells those investments, that increase in value will not produce any positive cash flow. Depreciation and changes in the value of investments are both examples of *reconciliations*. These are transactions that affect net assets but do not involve a cash flow.

In FY 2022, Treehouse produced its Statement of Cash Flows using the indirect method. Treehouse reported a positive change in net assets or surplus at the end of FY 2022 (\$5.6 million). Using the Statement of Cash Flows, we want to understand how core operations contributed to the nonprofit's operating position (\$5.6 million) and whether that operating position resulted in higher cash balances. Skip down to the row "*Net cash flows from operating activities*," and you will see that in FY 2022, Treehouse's operating activities resulted in a net cash outflow of \$1.8 million. In other words, while the nonprofit reported a large surplus, that surplus did not result in an increase in cash. In fact, core operations resulted in a \$1.77 million decrease in cash balances.

To appreciate these differences, review the reconciliations reported under "*Adjustments to reconcile change in net assets to net cash flows from operating activities*." Recall that the figures in this part of the statement are reconciliations, so we interpret them inversely. Any activity that decreases net assets is shown here as a positive value because we are "*adding back*" those activities to arrive at Net Cash Flows from Operations. Any activity that would increase net assets is shown as a negative value (or in parentheses) because we are "*backing out*" those activities to arrive at Net Cash Flows from Operations.

Treehouse reported several reconciliations in FY 2022. Treehouse reported \$286,275 in depreciation expense. Depreciation expenses decrease net assets. We add back depreciation to the Change in Net Assets to arrive at Net Cash Flows from Operations – i.e., the estimate of the change in cash flows from operating activities.

Treehouse reported an increase in discounts and allowances for uncollectables of \$24,422. That increase in discounts and allowances decreases Change in Net Assets. We reconcile this item by backing out the change in allowances.

Treehouse received \$336,936 in donated investments and \$7.097 million in donated interest in the 2100 building. These transactions increase net assets (or profitability) but do not produce a positive cash flow. We deduct (or back out) contributed property and investments from Change in Net Assets. The same logic applies to realized and unrealized losses (gains) on investments. Treehouse reported \$1,568,107 in investment losses at the end of FY 2022. Since these cash flows are restricted, and all cash flows are reported under investments – not cash – we add (or deduct) back that loss (gain) from Change in Net Assets.

Below the reconciliations, you will see "*Change in Operating Assets and Liabilities*." The figures listed here are also reconciliations, this time to reconcile changes in assets and liabilities that do involve cash to Changes in Net Assets. The key here is that we are focused on changes in assets and liabilities as a result of cash flows. So, to make sense of the Change in Operating Assets and Liabilities section, first, think about how typical assets and liabilities interact with cash.

Cash balances are lower if assets other than cash are higher. If, for example, receivables are higher this year compared to the previous year, cash balances will be lower – in other words, the payment

we should have received for a donated pledge or services provided has yet to be received. Consider contracts and other receivables. In FY 2022, contracts receivable was \$3,528,538. In FY 2021, contracts receivable was \$1,141,268. The increase in receivables implies that payments were pending, so our cash balances are \$2,387,270 lower. The same logic applies to prepaid expenses, which increased from \$46,213 at the end of FY 2021 to \$364,127 at the end of FY 2022. The same logic applies when assets other than cash and investments increase. For example, balances in contributions receivable in FY 2022 were \$195,182 – \$386,917 lower than they were in FY 2021 (\$582,099). That reduction resulted in an increase in cash. The same logic applies to inventories and unemployment trust deposits.

Change in Asset or Liability	Net Change in Cash & Cash Equivalents
<i>Increase</i> in an asset account	<i>Decrease</i> in Cash & Cash Equivalents
<i>Decrease</i> in an asset account	<i>Increase</i> in Cash & Cash Equivalents
<i>Increase</i> in a liability account	<i>Increase</i> in Cash & Cash Equivalents
<i>Decrease</i> in a liability account	<i>Decrease</i> in Cash & Cash Equivalents

Cash balances are higher if balances in liability accounts are higher. Given the focus on Net Cash Flows from Operations, we focus here on accounts payable, other liabilities, and accrued salaries and related costs. As we noted earlier, any change in balances of any notes payable or loan payable would be reported in Net Cash Flows from Financing Activities. More on this below.

Consider Accounts payable. In FY 2022, accounts payable were \$143,584, nearly half the balance reported at the end of FY 2021 (\$286,030). This decrease in payables implies payments were made, as such, cash balances are \$142,446 lower. Conversely, balances in other liabilities and accrued salaries and related costs were higher in FY 2022. Delayed payments mean the non-profit holds more cash now, so cash balances are higher (\$266,444 and \$113,227, respectively).

The *Cash Flows from Investing Activities* and *Cash Flows from Financing Activities* sections are more intuitive. Like before, an increase in an asset account reported under Investing Activities (e.g., Investments or Property and Equipment) results in a decrease in cash and cash equivalents and vice versa. An increase in a liability account reported under Financing Activities (e.g., Loan Payable) results in an increase in cash.

Returning to Treehouse, we see that in FY 2022, it purchased \$286,933 in furniture and equipment and \$195,512 in investments. The nonprofit reported the sale of investments (\$1,129,561). The net effect of investing activities was \$647,116 – in other words, investing activities (including the sale of investments) increased the cash position of the nonprofit.

Treehouse did not report any Cash Flows from Financing Activities. It did not report any long-term obligations, did not draw on any line of credit, and did not rely on borrowed funds. This reflects the nonprofit’s strong financial position but also the choice of the board to use internal resources to manage its cash position.

We can draw two immediate and important conclusions from Treehouse’s Statement of Cash Flows.

First, the non-profit reported a large surplus (\$5,622,029). While there were changes in account balances related to the non-profit operating activities, those activities did not generate cash. As a result, net cash flows from operating activities are negative (\$1,739,671). The nonprofit relied on proceeds from the sale of investments to improve the organization's cash position. At the end of FY 2022, the nonprofit's cash position had declined from \$5,552,763 at the start of the year to \$4,430,208 at the end of the year. While the cash position has declined, it's important to contextualize those findings. The nonprofit reported a large surplus because of a significant increase in revenues and the value of donations (investments and interest in building). While the nonprofit does not expect to liquidate the donated space, the contracts and other receivables should be collected in the next 12 months, improving the nonprofit's cash position.

STATEMENT OF FUNCTIONAL EXPENSES

One of the central questions in non-profit financial management is: How well does this organization accomplish its mission? From a financial standpoint, one way to answer this question is to determine how much of the organization's expenses are related to its core, mission-related services. In the language of accounting, this distinction is *program services* vs. *support services* (i.e., *administrative services*). According to paragraph 28 of FASB Statement 117, program services are "activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists." Support services are everything else: fund-raising, communications, management, administrative support, and other activities necessary to deliver program services.

Donors want to support a non-profit's primary goals. They want to know if their contribution improved a child's education, fed the hungry, funded scientific research, or advanced objectives outlined in the organization's mission. They are less interested in funding rent, insurance, professional memberships, administrators' salaries (gasp!), or other support services. To be clear, support services are essential. They're just not sexy. That is why one of the most closely watched numbers in non-profit financial management is the program expense ratio, computed as total program service expenses/total expenses. Many donors look for organizations with comparatively high program expense ratios, and many non-profit leaders work hard to minimize their support service expenses for that same reason.

The program services vs. support services distinction is so important that GAAP calls for a fourth basic statement to illustrate it. This statement is called the *Statement of Functional Expenses*. It shows three basic categories of expenses:

1. **Program.** Many non-profits report their program expenses separately for each of their major mission or programmatic areas.
2. **Management and General** are principally salaries and benefits for administrators, technical support services like accounting and information technology, and reconciliation expenses in areas like depreciation.
3. **Fundraising** includes expenses related to fundraising and special events, identifying and contacting donors, and other expenses associated with soliciting and generating contributions.

Treehouse
Consolidated Statement of Functional Expenses
Year Ended June 30, 2022

	Program Services			Total Program Services	Support Services			Total
	Education Programs	Enrichment Programs			Management and General	Fundraising	Total Support Services	
		Free Store	Other					
Payroll	\$ 4,395,285	\$ 314,944	\$ 3,256,070	\$ 7,966,299	\$ 534,943	\$ 1,489,412	\$ 2,024,355	\$ 9,990,654
Payroll taxes and benefits	1,095,975	73,316	689,588	1,858,879	153,356	158,137	311,493	2,170,372
Free Store & Holiday Magic	-	805,346	-	805,346	-	-	-	805,346
Assistance to specific individuals	-	-	5,740,043	5,740,043	-	-	-	5,740,043
Occupancy	-	240,000	167,947	407,947	52,778	5,090	57,868	465,815
Professional services	301	22,191	1,161,957	1,184,449	584,639	278,936	861,575	2,046,024
Transportation	59,528	3,277	41,356	104,161	6,351	1,360	7,711	111,872
Licenses and fees	-	16,886	820,303	837,189	202,811	12,623	215,434	1,052,623
Special events	-	-	-	-	-	109,479	109,479	109,479
Depreciation	-	4,745	230,364	235,109	49,030	2,135	51,165	286,274
Supplies	22,130	8,903	28,496	59,529	2,435	5,639	8,074	67,603
Printing and publications	797	620	19,818	21,235	24,781	37,681	62,462	83,697
Postage and shipping	521	12,335	77,715	90,571	12,080	479	12,559	103,130
Staff training	2,607	2,158	114,428	119,193	14,208	11,186	25,394	144,587
Credit card fees	-	5	8,716	8,721	30	108,775	108,805	117,526
Insurance	-	1,582	76,785	78,367	8,857	8,198	17,055	95,422
All other operating expenses	7,621	6,182	47,088	60,891	13,256	34,913	48,169	109,060
Total operating expenses - 2022	\$ 5,584,765	\$ 1,512,490	\$ 12,480,674	\$ 19,577,929	\$ 1,659,555	\$ 2,262,043	\$ 3,921,598	\$ 23,499,527

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Let's return to Treehouse and examine its Statement of Functional Expenses. Treehouse reports expenses for each of its main programs in the first three columns from the left.

Education programs are by far the largest spending area. In FY 2022, Education programs were \$5.6 million, or 23.7 percent of the organization's total expenses. The previously mentioned Treehouse Free Store program expenses were \$1.5 million (6.4 percent of total spending), and all "other" programs were \$12.5 million (53.1 percent of total expense).

Total expenses in all program services in 2022 were \$19.6 million, or 83.3 percent of total spending. In other words, the *program service ratio* is 83.3 percent. To put it one more way, 83 cents of every dollar Treehouse spends goes directly to fund the organization's core programs.

One appealing feature of the Statement of Functional Expenses is that the expense categories are intuitive. Items like payroll, payroll taxes and benefits, occupancy (i.e., expenses related to maintaining buildings), licenses and fees, and transportation are self-explanatory.

Like many other human services-focused non-profits, most of Treehouse's spending on support services is for fund-raising, and most of its spending on support services overall is for payroll. The same applies to spending on education programs. All these functions are labor-intensive.

BASIC FINANCIAL STATEMENTS – STATE AND LOCAL GOVERNMENTS

The basic financial statements of state and local governments include four sets of financial statements.

- **Government-wide statements** – *Statement of Net Position* and *Statement of Activities* that report on the government as a whole and with a long-term focus.
- **Fund Statements**, including the:
 - **Governmental fund statements** – the *Balance Sheet* and *Statement of Revenues, Expenditures, and Changes in Fund Balance* report on activities financed with revenues from taxes, intergovernmental transfers, and other non-exchange or non-market transaction-based revenue sources with a short-term focus.
 - **Proprietary fund statements** – the *Statement of Net Position, Statement of Revenues, Expenses, and Changes in Net Position*, and *Statement of Cash Flows* report on business-type activities of the government that are financed primarily with user charges and fees with a long-term focus.
 - **Fiduciary fund statements** – the *Statement of Net Position* and *Statement of Changes in Net Position* that account for funds held by the government in a trustee or agency capacity.

GOVERNMENT-WIDE STATEMENTS

Governments prepare government-wide financial statements that are like the basic financial statements for a non-profit or for-profit entity. **Government-wide statements help users assess the finances of the government in its entirety.** These government-wide statements answer key questions taxpayers ask about their government:

- Has the government’s overall financial position improved or deteriorated?
- Were its current-year revenues sufficient to cover the full costs of services?
- How much did the government invest in infrastructure and other capital improvements?
- How much does it depend on user fees and other exchange-like revenues compared to general tax revenues?
- How does its financial position compare to other, similar governments?

To illustrate, let’s look at the financial statements for the City of Bothell, WA. The City of Bothell, part of the Seattle metropolitan area, is in King and Snohomish counties. In 2021, its population was just under 48,920.

STATEMENT OF NET POSITION

Let’s start with Bothell’s government-wide balance sheet, formally known as the *Statement of Net Position*. It shows Bothell’s balances for its assets, liabilities, and net position on the final day of its fiscal year (December 31, 2021). This statement includes separate presentations for *governmental activities* and *business-type activities*. Taxes and other non-exchange revenues support governmental activities. Business-type or proprietary activities are supported by *exchange-like revenues* or fees the government charges for goods and services it delivers. For local governments, government-owned

utilities (water, gas, electric, sewer, solid waste), recreational facilities (e.g., convention centers, golf courses, hotels, swimming pools, ice arenas, etc.), and other enterprises are almost always considered business-type activities. For state governments, business-type activities often include state lotteries, unemployment benefit funds, workers' compensation funds, university tuition assistance programs, public hospitals, universities, community colleges, and public authorities supporting housing and economic development, to name a few.

On the asset side, we see many of the same assets reported in the Statement of Financial Position for Treehouse. The city of Bothell reports cash and cash equivalents, investments, receivables, restricted assets, and capital assets (non-depreciable and depreciable). Recall assets will be listed in *reducing order of liquidity* – the most liquid assets, cash and cash equivalents, are reported first, and the least liquid assets – capital assets (or infrastructure investments) and net pension assets – are listed last.

Governments will report amounts owed to the city for goods or services (e.g., outstanding payments for licenses, permits, fines, rents, royalties, or charges for services) separately from amounts due from taxes. *Taxes receivables* consist of property taxes and related interests and penalties the city of Bothell was owed at the end of 2021. Keep in mind that governments will report receivables for *special assessments* (a surtax in addition to the regular property tax) separately from taxes receivable as funds are used to fund specific activities (e.g., sidewalks, street lighting, economic development activities, etc.). Governments will also report receivables *due from other governments*. These capture inter-local agreements or cross-jurisdictional sharing arrangements common in areas like transit, emergency management, police and fire response, and public health.

It is important to note that this is the only financial statement that will report the value of the government's investment in infrastructure or capital assets. Capital assets may be reported by type (e.g., land, buildings, leased assets, infrastructure, etc.) or classification (e.g., depreciable versus non-depreciable). Capital assets are reported at historical costs. Depreciable capital assets are reported net of depreciation.

Liabilities are listed in *increasing order of maturity*. Maturity refers to the moment in time when payment is due. The proportion due in the next twelve months is reported under "due within one year." The accounts payable, unearned revenue, long-term liabilities, and other post-employment benefits due within one year are considered current liabilities. The remainder is non-current.

The city reported *unearned revenue*, sometimes referred to as *deferred revenue*. Unearned revenues represent revenues the government has received for services it has yet to provide. If the city fails to provide services, it will need to issue refunds. If the city owed another government based on an inter-local agreement, that obligation would appear here as *due to other governments*.

The city reports long-term liabilities, *other post-employment benefits* (OPEB), and *net pension liability*. Long-term liabilities include a variety of bonds (*general obligation* and *revenue*), as well as loans and leases associated with capital improvements. State and local governments finance most of their infrastructure improvements with long-term loans, bonds, notes, and leases that are paid off over 20 to 30 years. Cities, counties, and school districts rarely cease operations, even when they go bankrupt, so investors are willing to invest in them for long periods. It is quite different for non-profits or for-profits, where the *going concern* question is not always so clear.

Net pension liability represents the net obligation of retirement benefits the government owes its current employees, retirees, and beneficiaries. It represents the difference between the present value of projected retirement benefits and the plan assets, mainly financial investments. A net pension liability is reported if the current value of investments is less than the present value of projected benefits. If the current value of investments is greater than the present value of projected benefits, a *net pension asset* is reported. A majority of governments report pension and OPEB liabilities. OPEB (also known as other-post employment benefits) liabilities represent the net obligation of benefits other than pension benefits (principally healthcare benefits – including medical, dental, vision, hearing, death benefits, life insurance, disability, and long-term care) a government owes its employees and retirees. While governments have consistently funded their pension plans, few have set aside funds to meet their OPEB obligations. This is true for the city of Bothell – which reported \$1.5 million in net pension liabilities and more than \$6.5 million in OPEB obligations at the end of FY 2021.

Statement of Net Position
December 31, 2021

	Primary Government		Total
	Governmental Activities	Business-Type Activities	
ASSETS			
Cash and cash equivalents	\$ 43,625,978	\$ 3,098,118	\$ 46,724,096
Investments	52,673,731	18,962,038	71,635,769
Receivables (net)	14,129,337	2,944,749	17,074,086
Taxes receivable	577,654	-	577,654
Restricted assets:			
Deposit held in trust	277,395	-	277,395
Investment	-	1,316,369	1,316,369
Capital assets:			
Non-depreciable	190,905,806	5,381,078	196,286,884
Depreciable, net	410,067,171	57,208,806	467,275,977
Net pension asset	40,016,250	2,575,986	42,592,236
Total assets	752,273,321	91,487,144	843,760,466
DEFERRED OUTFLOWS OF RESOURCES			
Deferred outflows - pension	4,183,827	297,567	4,481,394
Deferred outflows - other postemployment benefits (OPEB)	66,836	-	66,836
Total deferred outflows of resources	4,250,663	297,567	4,548,230
LIABILITIES			
Accounts payable	8,598,730	797,056	9,395,786
Unearned revenue	6,687,001	-	6,687,001
Long-term liabilities (see Note 13):			
Due within one year	8,391,210	1,209,592	9,600,803
Due in more than one year	109,404,132	14,040,304	123,444,436
Total other postemployment benefits (OPEB):			
Due within one year	197,584	-	197,584
Due in more than one year	6,391,449	-	6,391,449
Net pension liability - due in more than one year	1,489,772	-	1,489,772
Total liabilities	141,159,878	16,046,952	157,206,831
DEFERRED INFLOWS OF RESOURCES			
Deferred inflows - pension	28,361,837	2,417,444	30,779,281
Deferred inflows - advanced grant	-	12,909	12,909
Total deferred inflows of resources	28,361,837	2,430,353	30,792,190
NET POSITION			
Net investment in capital assets	510,712,545	47,625,783	558,338,328
Restricted for:			
Pension	17,541,429	443,200	17,984,630
Transportation	4,778,189	-	4,778,189
Parks & Recreation	5,872,879	-	5,872,879
Capital projects	20,131,126	-	20,131,126
Street maintenance	4,902,348	-	4,902,348
Drug forfeitures	205,570	-	205,570
Fire impact fees	450,164	-	450,164
Public safety levy	6,113,168	-	6,113,168
Debt service	3,974	1,316,369	1,320,343
Firefighter's Pension	369,116	-	369,116
Cemetery (permanently restricted)	16,321	-	16,321
Other purpose	628,105	-	628,105
Unrestricted	15,277,335	23,922,054	39,199,389
Total net position	\$ 587,002,269	\$ 73,307,406	\$ 660,309,675

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Below total assets and total liabilities are two new categories of *deferrals* – *deferred inflows of resources* and *deferred outflows of resources*. A government records a deferred inflow of resources when it receives resources as part of a non-exchange transaction in advance. Pre-paid property taxes are a good example. Imagine a property owner in Bothell who paid property taxes for 2022 in October of

2021. The City of Bothell might be tempted to call this *deferred revenue* because it received payment in advance for services it will deliver next year. However, that would be incorrect because property taxes are a *non-exchange revenue*. Taxpayers in Bothell do not pay property taxes for specific services at specific times; they pay for a variety of services delivered at various times throughout the year. There is no real exchange. In this case, the city would recognize the taxpayer's payment as an asset but simultaneously recognize a *deferred inflow of resources*. Next year, when the city delivers services funded by property taxes, it will reduce cash and reduce that deferred inflow.

The inverse is true for deferred outflows. Say, for example, that most of the city's employees belong to the public employee retirement system (there are several, including PERS 1, PERS 2/3, PSERS 2, LEOFF 1, LEOFF 2). The pension systems, collectively administered by the State of Washington, send the city a bill for \$2.7 million to cover pensions and other costs related to the city's employees. That bill is due on January 20, 2022. If, before the city closes its books on December 31, 2021, the city council signs papers acknowledging its commitment to making that \$2.7 million payment shortly after the start of the coming fiscal year, those resources are effectively unavailable for the following year. The City of Bothell might be tempted to classify this under accounts payable because it owes money. But that is not entirely true. A state retirement system is not a service, and even if it were, it would not deliver that service until the next fiscal year. Instead, the city will book this as a deferred outflow of resources and book a corresponding increase in liabilities. By not booking a liability and not spending the cash, the city's balance sheet looks much stronger. At the same time, it has committed resources to the future, which will impact its operations in the coming year. By recognizing a deferred outflow of resources, the city has offered us a clearer picture of how well the resources it collects each year cover its annual spending needs.

With the addition of deferrals, we re-write the fundamental equation for the government-wide financial statements as

$$\text{Assets} + \text{Deferred Outflows} = \text{Liabilities} + \text{Deferred Inflows} + \text{Net Position}$$

In the traditional fundamental equation, we use "net assets" to identify assets minus liabilities. When we add deferrals, the "net assets" label no longer captures everything on the right side of the equation, but "net position" does. Net position and its components are also a uniquely governmental reporting feature. Here, Bothell's net position is similar to other states and local governments.

- *Net Investment in Capital Assets* is the historical cost of capital improvements or infrastructure investments – net of depreciation – and debt associated with the acquisition, construction, or improvement of capital assets. All capital assets are reported in this component of net assets, even if there are legal or other restrictions on how the government uses them for service delivery.
- Governments restrict portions of their net position for many purposes. *Restricted net position* is virtually the same as restricted net assets for a non-profit. According to governmental GAAP, a portion of net position is restricted if: 1) an external body, like bondholders or the state legislature, can enforce that restriction, or 2) the governing body passes a law or other action that imposes that restriction. If there are assets that are restricted, that restriction will be reported in the net position. The city reports a restricted net position for a wide variety of activities, including transportation, parks, and street maintenance. These restrictions are

based on laws adopted by the governing board or contracts with an external third party (e.g., bondholders).

- The government's *unrestricted net position* is akin to a non-profit's unrestricted net assets. These are net assets available for spending in the coming fiscal year. A negative unrestricted net position occurs if liabilities exceed assets. This does not mean the government is on the brink of fiscal disaster. It simply means the government's non-current liabilities, particularly retiree benefit obligations, far exceed its unrestricted non-capital assets. Governments reporting a sizeable unfunded liability are more likely to report a negative unrestricted net position.

WHAT'S A STREET "WORTH"?

When we look at Net Investment in Capital Assets, we are forced to evaluate the "book value" of a capital asset. Recall that most organizations – public and private – record their tangible capital assets at historical cost. That means they record a new asset at whatever it cost to construct or purchase it and then depreciate it over its useful life. Most of the fixed assets non-profits carry on their books – buildings, vehicles, office furniture, etc. – have useful lives of 10-30 years. But how does a government determine the book value of a street? Or a school building? Or a sewer system? Many were built long before governments started preparing modern financial statements, and many of them have useful lives of more than 100 years.

States and localities dealt with precisely this issue when they implemented Governmental Accounting Standards Board (GASB) Statement 34. This statement, euphemistically known as "GASB 34," required governments to report the book value of their capital assets. Prior to GASB 34, governments reported what they spent each year on capital assets as an expense, but they did not include their full book value. In other words, they did not capitalize on their infrastructure assets.

Fortunately, many governments were able to reconstruct historical cost figures by reviewing old invoices, purchase orders, construction plans, and other documents. Public works staff at state and local governments around the country spent thousands of hours researching old records to determine what they spent to build their original streets, bridges, sewer systems, university buildings, and other key pieces of infrastructure. Those assets were then grouped into fixed asset networks, assigned a useful life and a depreciation schedule, and depreciated to the present day. That depreciated figure became the original capitalized infrastructure asset value.

So, for most governments, the figure Net Investment in Capital Assets is the original capitalized value depreciated to a present-day value, plus any investments since implementing GASB 34. A few governments take a different approach allowed under GASB 34, known as the modified method. Here, a government capitalizes its infrastructure assets, but instead of depreciation, it estimates how much it will need to spend each year to maintain those assets in good working condition. If it can demonstrate that it's making those investments, it need not depreciate, and the book value does not change.

Why take the time and effort to do this? Because investors and taxpayers want to know if the government is taking care of its vital infrastructure. If the Net Investment in Capital Assets is stable or increasing, it suggests a government is precisely making those investments.

STATEMENT OF ACTIVITIES

A government's *Statement of Activities* presents much of the same information we see on the income statement for a for-profit or non-profit. It lists a government's revenues and expenses or expenditures and the difference between them. It reports the change in net assets or net position and explains why that change happened. Like an income statement, it tells us where the government's money came from, where it went, and whether its core activities pay for themselves.

That said, the Statement of Activities is also quite different from a traditional income statement. *Expenses* in the upper left are presented first. These are listed by function or program, with the *governmental activities* presented separately from the *business-type activities*. Recall that governmental activities are those supported by taxes and other *non-exchange revenues*. In contrast, business-type activities are supported with *exchange-like revenues*, primarily user charges and fees. Governmental activities and business-type activities together comprise the *primary government*. Next to expenses, you may occasionally see (although not with Bothell) indirect expenses the government has allocated to each activity (more on this in Chapter 5).

Statement of Activities
For the Year Ended December 31, 2021

Functions/program	Expenses	Program Revenues			Net (Expense) Revenues and Changes in Net Position		
		Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Governmental Activities	Primary Government Business-Type Activities	Total
Primary government:							
Government activities:							
General government	\$ 18,943,497	\$ 6,079,031	\$ 795,460	\$ -	\$ (12,069,005)	\$ -	\$ (12,069,005)
Security of persons and property	26,724,920	6,829,797	2,067,268	-	(17,827,855)	-	(17,827,855)
Physical environment	2,154,053	1,625,408	111,151	-	(417,495)	-	(417,495)
Transportation	50,610,973	752,450	996,532	12,354,275	(36,507,716)	-	(36,507,716)
Economic environment	4,897,604	11,191,305	109,281	-	6,402,981	-	6,402,981
Culture and recreation	2,098,286	287,202	6,080	308,993	(1,496,011)	-	(1,496,011)
Interest	3,933,715	-	-	-	(3,933,715)	-	(3,933,715)
Total governmental activities	109,363,047	26,765,193	4,085,772	12,663,267	(65,848,816)	-	(65,848,816)
Business-type activities:							
Water	5,623,205	6,342,408	241	382,712	-	1,102,156	1,102,156
Sewer	7,747,885	8,851,058	198	289,043	-	1,392,414	1,392,414
Storm & surface water	5,733,509	6,908,221	7,324	1,094,538	-	2,276,575	2,276,575
Total business-type activities	19,104,599	22,101,687	7,763	1,766,293	-	4,771,144	4,771,144
Total primary government	128,467,646	48,866,880	4,093,535	14,429,560	(65,848,816)	4,771,144	(61,077,671)
General Revenues:							
Property taxes					27,025,250	-	27,025,250
Sales taxes					19,298,152	-	19,298,152
Excise taxes					8,623,599	-	8,623,599
Business taxes					7,261,144	-	7,261,144
Interest and investment earnings					108,963	6,428	115,391
Miscellaneous					1,027,883	270,009	1,297,893
Transfers					408,265	(408,265)	-
Total general revenues and transfers					63,753,256	(131,828)	63,621,428
Change in net position					(2,095,559)	4,639,317	2,543,757
Net position - beginning					589,097,828	68,668,090	657,765,918
Net position - ending					\$ 587,002,269	\$ 73,307,406	\$ 660,309,675

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Program revenues include (a) charges for services, (b) operating grants and contributions, and (c) capital grants and contributions. Charges for services include revenues based on exchange or exchange-like transactions that can be directly linked to programs. For example, the city of Bothell reported \$6.1 million in charges under General Government. Revenues were from the sale of licenses and permits. The \$6.8 million in charges reported under the Security of persons and property include anything from fees for fire protection and emergency medical services to civil penalties, including parking fees and traffic violations. Charges for services will vary by type of government and scope of activities. The city reported \$4.1 million in operating grants and contributions and \$12.7 million in capital grants and contributions. A significant proportion of the capital grants and contributions were in Transportation. Business-type activities similarly reported operating (\$7,763) and capital (\$1.8 million) grants and contributions.

Shifting to the right, we see columns with the heading “Net (Expense) Revenue and Changes in Net Position.” **The net cost format nets program revenues from expenses.** The city reports a net expense of \$12,069,005 for the General government. This figure represents the sum charges for services, operating grants and contributions, and capital grants and contributions minus expenses (($\$6,079,031 + \$795,460 + \$0$) – $\$18,943,497$). This deficit (or net expense) tells us that general government activities do not pay for themselves. Similarly, public safety programs (police, fire, emergency medical services) do not pay for themselves ($-\$17,827,855$). **Governmental activities are not self-sustaining.** Except for the “economic environment,” every program reported a net expense (or deficit) – for a total of \$65.9 million.

Should the city council be concerned that its core services are hemorrhaging money? Not really. We do not want local government services like public safety, planning, and zoning to pay for themselves because there is no clear link between the users and the beneficiaries of these services. The city exacts fines on people who break the law when they park illegally or speed on city streets, but those fees are designed to deter those behaviors. Perpetrators who pay these fines do not receive a service, and as we saw in Ferguson, MO, and elsewhere, bad things happen when local governments turn fines into a viable revenue source.

But that leaves open an important question. Citizens want to see these essential services provided. How, then, do we help fund public transit or public safety?

To answer that question, skip down to the lower right corner of the statement. Here we see a list of *General Revenues* like property taxes, sales taxes, excise taxes, business taxes, and other revenues. General revenues are not directly connected to a specific activity. The city of Bothell reported \$63.8 million in general revenues for FY 2021. Compare that figure to the \$65.9 million in net expense for governmental activities – we are left with a decrease in the government’s net position for governmental activities of \$2.1 million. The city’s total revenues (taxes, charges and fees, and grants) were not sufficient to cover its expenses.

Should the city council be concerned with this figure? Well, it depends. We need to understand whether the negative change in net position resulted from a decline in revenues, an increase in expenses, or both. We also need to understand whether the changes resulted from changes in the economic environment, tax policy, or accounting standards. The answer, sometimes, is not as straightforward. As you will see in Chapter 3, more questions than answers will arise from any review of financial statements. That said, **the relationship between expenses, program revenues, and general revenues is one of the most important things to observe in a government’s Statement of Activities.**

The expense versus program revenues link is much more straightforward for business-type activities. Recall that business-type activities are designed to pay for themselves through charges and services. For the city of Bothell, Water, Sewer, and Storm Water reported net revenue of \$4.8 million at the end of FY 2021. Their operations were not subsidized with tax revenues.

Not all business-type activities are self-supporting, and not all business-type activities consistently report a surplus. For example, public universities and hospitals listed under business type are frequently subsidized with tax revenues. States will report transfers to business-type activities to

finance the operations of its universities and hospitals. The unemployment benefits program is another example of a program that reports sizeable surpluses when unemployment rates are low but reports sizeable deficits when unemployment rates are high, as benefit distributions in a recession will exceed program revenues. So again, it depends!

That said business-type activities present challenging strategic and policy questions. How profitable is too profitable? Moreover, should business-type activities subsidize governmental activities? If a business-type activity like a golf course is not profitable, does it offer enough indirect benefits in areas like economic development and tourism to justify that lack of profitability? With a careful look at the Statement of Activities, you can begin to put numbers to these and other questions.

ARE WE COMPONENTS?

A component unit is a legally separate entity for which the government is financially accountable. The primary government is financially responsible if it can appoint a voting majority to the unit's governing body, if the component unit can impose financial burdens on the primary government, or if the unit is fiscally dependent on the primary government. Special districts like local development authorities, transportation improvement districts, and library districts are typical local government component units. Component units reported by larger governments, including states, include housing authorities, tollway authorities, public insurance corporations, state lotteries, and state universities.

Most component units are small relative to the primary government. But some are pretty large. The Cherokee Nation of Oklahoma (www.cherokee.org), for example, counts among its component units three casinos, a housing development company, a home health services company, a public health insurance company, a waste management company, a large community foundation, a historic preservation society, and an economic development corporation, among others. At the end of FY 2022, total revenues from the primary government were \$2.17 billion. Revenues of the various components of the Cherokee Nation were \$2.14 billion.

THE FUND STATEMENTS

A fund is a stand-alone, self-balancing set of accounts with a specific purpose. Funds are one of our main tools to assess a government's *fiscal accountability*. Fiscal accountability is the responsibility of governments to justify that their actions in the current period have complied with public decisions concerning the raising and spending of public money (GASB Statement 34). That responsibility is fundamental to financial reporting and why governments prepare separate fund-based financial statements. They include:

- a. **Governmental Fund Statements** that report on activities financed primarily with revenues from taxes, intergovernmental transfers, and other non-exchange or non-market transaction-based revenue sources. Governments will prepare a *Balance Sheet* and a *Statement of Revenues, Expenditures, and Changes in Fund Balances* for the governmental funds.
- b. **Proprietary Fund Statements**, which report on business-type activities of the government that are financed primarily with user charges and fees. Financial statements include a *Statement of Net Position*, a *Statement of Revenues, Expenses, and Changes in Net Position*, and a *Statement of Cash Flows*.
- c. **Fiduciary Fund Statements** account for funds held by the government in a trustee or agency

capacity. Governments will prepare a *Statement of Net Position* and a *Statement of Changes in Net Position*.

GOVERNMENTAL FUND STATEMENTS

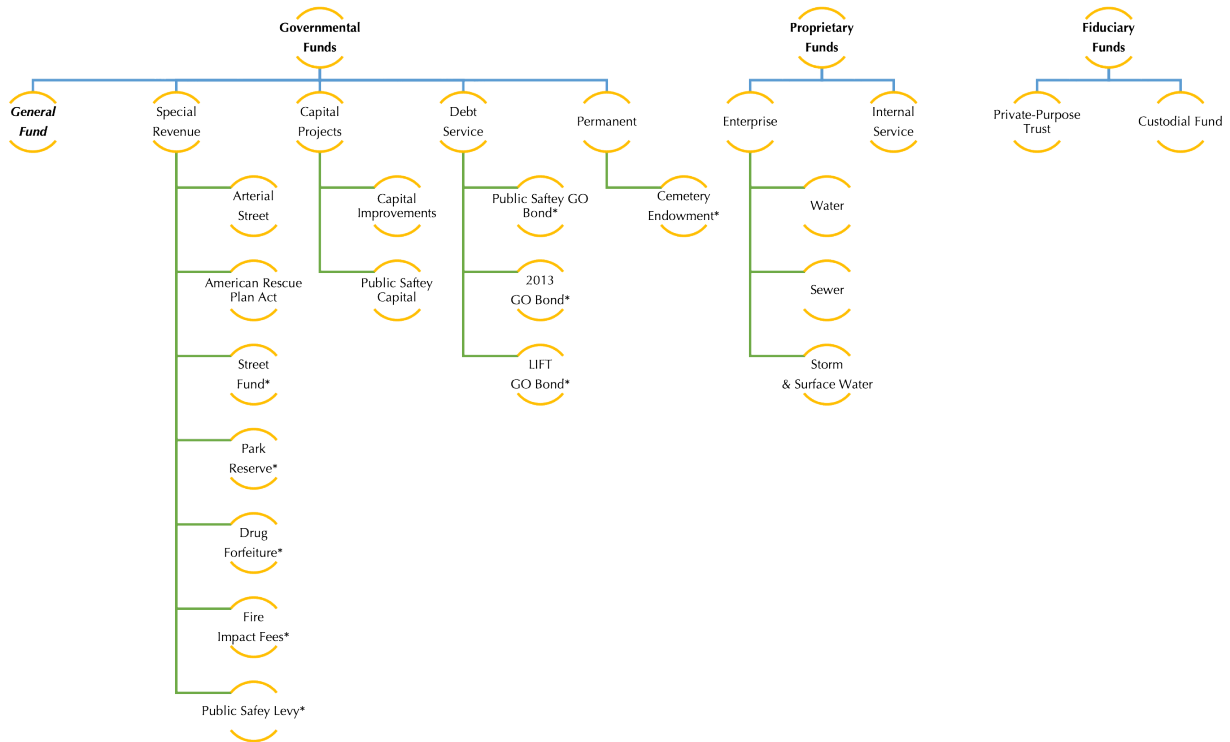
The governmental fund statements are prepared on a different basis of accounting, known as *modified accrual* accounting. Modified accrual accounting is designed to reflect this unique focus on short-term fiscal accountability. To that end, we rewrite the fundamental equation of accounting for the modified accrual context as follows

$$\text{Assets} + \text{Deferred Outflows} = \text{Liabilities} + \text{Deferred Inflows} + \text{Fund Balance}$$

In the governmental fund statements, we care most about fund balance – the difference between assets and liabilities in each fund. **Fund balance is the most closely watched number in all governmental accounting.** Taxpayers seem to understand that if a government is living within its means, then its assets should be greater than its liabilities, and it will report a positive fund balance. Policymakers seem to understand that ending the fiscal year with a positive fund balance means there is a bit of money to spend in the next fiscal year. That’s why many fiscal policy and financial strategy discussions often come back to a simple “Goldilocks” question: *Is our general fund balance too large, too small, or just right?*

It is important to note that the change to reporting on a modified accrual basis does not apply to proprietary or fiduciary fund statements. In fact, proprietary and fiduciary fund statements are prepared using the same accounting basis used to prepare government-wide statements. So why prepare an additional set of financial statements if the same basis of accounting applies? Again, the idea goes back to the responsibility of governments to fulfill their fiscal accountability responsibility. More on this below.

Fund Structure - City of Bothell



*The "Combining Financial Statements" are included in the Required Supplementary Section of the Annual Comprehensive Financial Reports (ACFRs) and provide details on each non-major fund. For the city of Bothell, there were no non-major funds in the Proprietary Fund.

The governmental fund statements report on a fund basis on activities in the general fund, special revenue funds, capital projects funds, debt service funds, and permanent funds. The city of Bothell reports fourteen separate funds in the governmental fund statements, four in its proprietary fund statements, and two in fiduciary funds. The larger the government or, the more complex its operations are, the more likely it will report a multitude of funds.

Critics of government financial reporting often say that governments have too many funds. That is true. But **government finances are complex**. They are spread across many reporting units and serve a wide variety of mandates. So, while fund statements are cumbersome, they are the best available means to ensure fiscal accountability. Below is a quick tour of the fund statements. We begin with a review of the governmental fund statements.

BALANCE SHEET

GAAP requires governments to prepare a balance sheet that shows the assets, liabilities, and fund balance in every major governmental fund and the combined assets, liabilities, and fund balance in non-major funds.

Bothell's governmental fund Balance Sheet is presented here. It shows three discretely presented funds – the General Fund, two special revenue funds (Arterial Street and American Rescue Plan Act), and two capital projects funds (Capital Improvements and Public Safety Capital). All other funds are reported in aggregate in the "Other Governmental Funds." They include five special revenue funds (Street Fund, Park Reserve, Drug Forfeiture, Fire Impact Fee, and Public Safety Levy), three

debt service funds (Public Safety GO Bond, 2013 GO Bond, and LIFT Bond), and a permanent fund (Cemetery Endowment).

THAT'S HOW WE ROLL

Most governments have dozens, if not hundreds, of individual funds. It's not feasible to report on all of them in the financial statements. To simplify financial reporting, governments draw a distinction between major funds and non-major funds. A fund is classified as a major fund if government officials believe that the fund is particularly important to financial statement users (e.g., the General Fund) or whose total assets plus deferred outflows of resources, liabilities plus deferred inflows of resources, and revenues or expenditures/expenses are at least 10 percent of the relevant fund category (governmental or proprietary) and 5 percent of the corresponding total for all governmental and proprietary funds combined. GAAP requires a set of financial statements for each fund. The major funds are reported in the Basic Financial Statements. Non-major funds are reported in an aggregate format in the Basic Financial Statements and on a disaggregated basis in the Combining Statements, included in the Required Supplementary Section of the Annual Comprehensive Financial Reports (ACFRs).

Basic Financial Statements

City of Bothell

Balance Sheet Governmental Funds December 31, 2021							
	General	Special Revenue Funds		Capital Projects Funds		Other Governmental Funds	Total Governmental Funds
		Arterial Street	American Rescue Plan Act	Capital Improvements	Public Safety Capital		
ASSETS							
Current cash & cash equivalents	\$ 12,863,100	\$ 1,797,722	\$ 6,410,842	\$ 13,245,389	\$ -	\$ 6,917,951	\$ 41,235,005
Investments	5,974,970	3,000,000	-	1,900,000	28,674,581	10,824,179	50,373,731
Receivables (net of allowances)							
Taxes	408,610	-	-	-	-	169,044	577,654
Accounts receivable, net	2,450,344	-	-	102,905	-	-	2,553,250
Due from other governmental units	6,586,014	-	-	4,755,964	-	175,191	11,517,170
Total assets	28,283,039	4,797,722	6,410,842	20,004,259	28,674,581	18,086,366	106,256,809
LIABILITIES, DEFERRED INFLOWS OF RESOURCES AND FUND BALANCES							
Liabilities:							
Accounts payable	796,760	-	1,105	1,303,051	3,255,770	100,599	5,457,284
Deposits payable	329,477	-	-	-	-	-	329,477
Due to other governmental units	110,567	-	-	194,732	-	221	305,520
Payroll payable	1,991,265	-	131	-	-	228,198	2,219,595
Unearned revenue	-	-	6,409,606	-	-	-	6,409,606
Total liabilities	3,228,070	-	6,410,842	1,497,782	3,255,770	329,018	14,721,482
Deferred Inflows of Resources							
Unavailable revenue-property tax, service fees & impact fees	797,821	19,533	-	-	-	136,267	953,621
Unavailable revenue-advanced grant	-	-	-	-	-	-	-
Total deferred inflows of resources	797,821	19,533	-	-	-	136,267	953,621
Fund balances:							
Restricted	1,008,256	4,778,189	-	18,506,476	25,418,811	17,553,388	67,265,121
Committed	3,516,750	-	-	-	-	67,692	3,584,442
Assigned	1,711,130	-	-	-	-	-	1,711,130
Unassigned	18,021,012	-	-	-	-	-	18,021,012
Total fund balances	24,257,148	4,778,189	-	18,506,476	25,418,811	17,621,081	90,581,705
TOTAL LIABILITIES, DEFERRED INFLOWS OF RESOURCES AND FUND BALANCES	\$ 28,283,039	\$ 4,797,722	\$ 6,410,842	\$ 20,004,259	\$ 28,674,581	\$ 18,086,366	\$ 106,256,809

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Bothell's General Fund has \$28.3 million in assets. General fund assets far exceed General Fund liabilities (\$3.2 million). The city reports deferred inflows related to pre-paid property taxes, special assessments, and grants. While the focus is the General Fund, a significant proportion of resources are restricted and reported outside the General Fund. For the city of Bothell, the General Fund only accounts for 27 percent of the \$106.3 million in assets.

The difference between assets and liabilities (net of deferred inflows and outflows) is Fund Balance. According to GAAP, there are five types of fund balance, each corresponding to the strength of restrictions on how fund balance resources can be spent:

- *Non-spendable* fund balance is, as the name suggests, not available for spending in the next fiscal period. Governments usually record non-spendable fund balances for items like inventory, legal settlements, small trust funds or endowment funds, or other long-term investments where the corpus of the investment must remain intact. Bothell did not report a non-spendable fund balance in any of its funds.
- The *restricted* fund balance, like restricted net assets, can only be spent on purposes prescribed in the government's constitution, enabling legislation, or some action from an external funder. Bothell, like many other local governments, reports restricted fund balance in the General fund (\$1.01 million), special revenue fund (\$4.8 million), capital projects funds (\$43.9 million), and other non-major funds (including cemetery endowment fund \$17.6 million) – for a total restricted fund balance of \$67.3 million.
- *Committed* fund balance includes amounts that can be used for purposes determined by a governing body's formal action. State and local legislators will occasionally commit fund balances for capital projects or other one-time spending needs or for *rainy-day* funds or other *budget stabilization* funds designed to prevent spending cuts during an economic downturn. The city of Bothell committed \$3.5 million in the General Fund and \$67,692 in other non-major funds (specifically the Cemetery Endowment Fund). Like most local governments, the City of Bothell does not report a formal *rainy day* In these instances, the unassigned fund balance becomes an important measure of liquidity (or short-term solvency).
- *Assigned* fund balance is restricted by some action other than a governing body commitment or other enforceable restrictions. Usually, this means restrictions that management places on fund balances without the approval of the governing body. The city of Bothell reported \$1.7 million in the General Fund as an assigned fund balance. Note 20 in the Notes to the Financial Statements provides additional detail on fund balances. In this instance, the \$1.7 million reported in the General Fund is currently assigned to capital projects. Unlike funds reported as committed or restricted, there is greater flexibility in reassigning funds to other uses. Therefore, we consider the assigned fund balance as an "*informal*" rainy day fund that management, not the governing body, maintains.
- The *unassigned* fund balance reports fund balances not subject to any restrictions. At the end of FY 2021, the city of Bothell reported \$18 million in unassigned fund balance. Again, the General Fund's unassigned fund balance is one of the most closely watched indicators of a government's overall financial position.

Some readers review the governmental fund balance and ask an intuitive question. *Do the fund balances*

in the governmental funds equal the net assets in the governmental activities we see on the government-wide Statement of Net Position? Fund balance and net assets are the residual left when we subtract liabilities from assets. If that is true, the fund balance should be equal to the net position. Except when we look at the two statements, it is quite evident they are not the same. Why? Again, this goes back to the bases of accounting used to prepare financial statements. The government-wide statements are prepared using the accrual basis of accounting with an economic resource measurement focus. In contrast, governmental fund statements are prepared using the modified accrual basis of accounting with a financial resource measurement focus. Given the *current* financial resources measurement focus, **there are no long-term assets or long-term obligations listed in the Balance Sheet.** For this, and a variety of other reasons, the fund balance reported in the governmental fund statements differs substantively from the net position reported in the Statement of Net Position.

As noted earlier, the city of Bothell reports nine non-major funds, including (a) Street, (b) Park Cumulative Reserve, (c) Drug Forfeiture, (d) Fire Impact Fee, and (e) Public Safety Levy, (f) the 2013 General Obligation Bond, (g) the 2014 Local Infrastructure Financing Tool (LIFT) Bond, (j) Public Safety GO Bond and (k) the Cemetery Endowment Fund. Detailed information on every fund can be found in “*Combining Financial Statements.*” The combining financial statements supplement the basic financial statements. The basic financial statements for governmental and proprietary funds have columns for each of the major funds and a single column in which all the nonmajor funds are aggregated. The combining statements provide the details of the nonmajor funds with one column for each.

Combining Balance Sheet
Other Governmental Funds
December 31, 2021

	Special Revenue Funds					Total Special Revenue Funds	Permanent Fund				Total Other Governmental Funds	
	Street	Park Cumulative Reserve	Drug Forfeitures	Fire Impact Fees	Public Safety Levy		Cemetery Endowment	2013 GO Bond	Lift GO Bond	Public Safety GO Bond		Total Debt Service Funds
ASSETS												
Current cash & cash equivalents	\$ 1,809,117	\$ 1,913,245	\$ 163,490	\$ 459,390	\$ 2,488,696	\$ 6,833,938	\$ 84,013	\$ -	\$ -	\$ -	\$ -	\$ 6,917,951
Investments	3,050,000	4,000,000	-	-	3,774,179	10,824,179	-	-	-	-	-	10,824,179
Receivables (net of allowances):												
Taxes receivable	72,831	-	-	-	74,845	147,676	-	-	-	21,368	21,368	169,044
Accounts receivable	-	-	-	-	-	-	-	-	-	-	-	-
Due from other governmental units	144,147	-	31,044	-	-	175,191	-	-	-	-	-	175,191
TOTAL ASSETS	\$ 5,076,095	\$ 5,913,245	\$ 194,535	\$ 459,390	\$ 6,337,720	\$ 17,980,985	\$ 84,013	\$ -	\$ -	\$ 21,368	\$ 21,368	\$ 18,086,366
LIABILITIES												
Accounts payable	49,015	40,366	-	9,226	1,992	100,599	-	-	-	-	-	100,599
Due to other governmental units	221	-	-	-	-	221	-	-	-	-	-	221
Payroll payable	65,927	-	-	-	162,271	228,198	-	-	-	-	-	228,198
Unearned revenue	-	-	-	-	-	-	-	-	-	-	-	-
Total liabilities	115,163	40,366	-	9,226	164,263	329,018	-	-	-	-	-	329,018
DEFERRED INFLOWS OF RESOURCES												
Unavailable revenue	58,584	-	-	-	60,290	118,873	-	-	-	17,394	17,394	136,267
Total deferred inflows of resources	58,584	-	-	-	60,290	118,873	-	-	-	17,394	17,394	136,267
FUND BALANCES												
Restricted	4,902,348	5,872,879	194,535	450,164	6,113,168	17,533,093	16,321	-	-	3,974	3,974	17,553,388
Committed	-	-	-	-	-	-	67,692	-	-	-	-	67,692
Total fund balances	4,902,348	5,872,879	194,535	450,164	6,113,168	17,533,093	84,013	-	-	3,974	3,974	17,621,081
TOTAL LIABILITIES, DEFERRED INFLOWS OF RESOURCES AND FUND BALANCES	\$ 5,076,095	\$ 5,913,245	\$ 194,535	\$ 459,390	\$ 6,337,720	\$ 17,980,985	\$ 84,013	\$ -	\$ -	\$ 21,368	\$ 21,368	\$ 18,086,366

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The “Combining Balance Sheet” reports assets, liabilities, and fund balances in each of these funds. Total assets reported here (\$18.1 million) are also reported, in a single column, in the Balance Sheet included in the Basic Financial Statements (see second-to-last column titled “Other Governmental Funds”). Again, the main difference here is that we now know how these assets are reported in each non-major fund. For example, we now know that the Public Safety Levy fund is the largest non-major fund (\$6.3 million in assets). We also know that of the \$5.1 million reported in the Street Fund, \$1.8 million was in cash and cash equivalents, \$3.1 million was in investments, and the remainder was in receivables. So why is reporting information in the combining statements important? If you are a resident of Bothell, you want to know if dedicated taxes for streets, parks, or public safety are reported in the appropriate special revenue fund – or that dedicated tax revenues are appropriately transferred from the General Fund to the special revenue fund. The Combining Financial Statements provide you with that additional information.

That said, there is not a lot of activity reported in the non-major funds. For that reason, the combining financial statements are relegated to the *Required Supplementary Section* of the ACFRs. The city reports fund balances in every special revenue fund and the sole permanent fund (i.e., the Cemetery Endowment fund). Two of the three debt service funds do not report fund balances. That is not unusual.

STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE

The *Statement of Revenues, Expenditures, and Changes in Fund Balance* is an income statement prepared on a modified accrual basis in the governmental fund statements. It lists the revenues, expenditures, and the change in fund balances. In this case, changes in fund balance are akin to changes in net assets or changes in net position.

Bothell's Statement of Revenues, Expenditures, and Changes in Fund Balances shows that its two largest overall revenue sources are taxes (\$40.5 million in the General Fund, \$62 million total). Other sources of revenue include licenses and permits (\$4 million in the General Fund, \$4.6 million total), intergovernmental revenue (\$2.8 million in the General Fund, \$14.9 million total), and charges for services (\$12.7 million in the General Fund, \$17.8 million total).

An expenditure is roughly equivalent to an expense, albeit on the modified accrual basis of accounting (again, more on this in Chapter 4). Nearly two-thirds of the city's total governmental funds expenditures are in the General Fund (\$55.4 million). More than half of Bothell's General Fund expenditures are for public safety (\$29.4 million). This is typical of mid- and large-sized suburban cities. The remainder of governmental fund expenditures go to administrative functions of the city (\$14.2 million), transportation (\$12.2 million), economic environment (\$5.9 million), capital outlays (\$18 million), and debt service (\$4.3 million). In general, non-capital expenditures in the General Fund are a good proxy for a government's "operating costs." Most of its salaries, benefits, and operational spending will appear as General Fund expenditures. By contrast, most of the revenues and expenditures in the special revenue and debt service funds will be related to capital spending and debt repayments, neither of which are considered day-to-day operations costs.

At the bottom of this statement, we also see "*other financing sources*." These are inflows and outflows of resources that affect fund balance, which are neither revenues nor expenditures. They frequently include loan or bond proceeds, proceeds from the sale of assets, and insurance recoveries, to name a few.

Statement of Revenues, Expenditures, and Changes in Fund Balances Governmental Funds
For the Year Ended December 31, 2021

	Special Revenue Funds			Capital Projects Funds		Other Governmental Funds	Total Governmental Funds
	General	Arterial Street	American Rescue Plan Act	Capital Improvements	Public Safety Capital		
REVENUES							
Taxes	\$ 40,450,611	\$ -	\$ -	\$ 8,623,599	\$ -	\$ 12,920,156	\$ 61,994,366
Licenses and permits	3,969,487	-	-	541,158	-	116,047	4,626,692
Intergovernmental revenues	2,842,205	-	214,759	10,863,104	-	1,026,162	14,946,230
Charges for services	12,663,650	3,501,226	-	-	-	1,626,978	17,791,854
Fines and forfeitures	197,922	-	-	-	-	88,034	285,956
Interest earnings	86,555	-	-	-	22,407	-	108,963
Contributions	11,363	-	-	66,542	-	-	77,906
Other revenue	787,452	-	-	83,046	-	1,247	871,744
Total revenue	61,009,245	3,501,226	214,759	20,177,450	22,407	15,778,624	100,703,711
EXPENDITURES							
Current							
General government	13,037,933	-	207,887	-	-	925,885	14,171,705
Security of persons and property	29,379,058	-	-	-	-	1,556,708	30,935,766
Transportation	5,271,282	-	-	4,370,189	-	2,522,019	12,163,491
Physical environment	22,322	-	6,871	-	-	-	29,193
Economic environment	5,218,407	-	-	681,344	-	-	5,899,751
Culture and recreation	2,074,024	-	-	-	-	-	2,074,024
Other expenditures	-	-	-	300	300	300	900
Debt service:							
Debt service - principal	-	-	-	1,976,759	-	2,000,000	3,976,759
Debt service - interest	11,012	-	-	1,820,835	-	2,307,700	4,139,547
Issuance costs	-	-	-	-	105,653	-	105,653
Capital outlay	365,048	-	-	9,890,413	7,464,886	291,819	18,012,166
Total expenditures	55,379,086	-	214,759	18,739,840	7,570,839	9,604,432	91,508,955
Excess (deficiency) of revenue over expenditures	5,630,160	3,501,226	-	1,437,610	(7,548,431)	6,174,192	9,194,756
OTHER FINANCING SOURCES (USES)							
Sales of capital assets	4,737	-	-	13,465,000	-	-	13,469,737
Proceeds from public safety bonds	-	-	-	-	8,135,000	-	8,135,000
Proceeds from public safety bond premium	-	-	-	-	1,859,659	-	1,859,659
Transfer in	6,750,194	-	-	5,363,973	-	1,691,963	13,806,130
Transfer out	(2,119,173)	(1,959,609)	-	(8,442,157)	-	(1,996,100)	(14,517,039)
Total other financing sources (uses)	4,635,758	(1,959,609)	-	10,386,816	9,994,659	(304,137)	22,753,487
Net change in fund balances	10,265,917	1,541,617	-	11,824,426	2,446,227	5,870,055	31,948,243
FUND BALANCE - BEGINNING	13,991,231	3,236,572	-	6,682,050	22,972,584	11,751,025	58,633,462
FUND BALANCE - ENDING	\$ 24,257,148	\$ 4,778,189	\$ -	\$ 18,506,476	\$ 25,418,811	\$ 17,621,081	\$ 90,581,705

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The last two lines of other financing sources are an important and sometimes controversial part of governmental accounting: *inter-fund transfers*. *Transfers in* are movements of resources into a fund from some other fund. *Transfers out* are movements of resources out of a fund into some other fund. For example, in 2021, the city transferred to the General Fund \$6.8 million. Transfers from the General Fund (\$2.1 million) were distributed to the Capital Improvement Fund and Internal Service Funds. How are we able to know this? Governments frequently chart the transfers to and from funds in the notes to the financial statements. Look for a note on "interfund transfers."

Critics say governments use inter-fund transfers to perpetuate a financial "shell game." By opportunistically transferring money in and out of funds (frequently known as fund sweeps) at just the right moment, the government can obscure its actual financial position. **How and when transfers can and should happen are important parts of financial strategy and policy.**

WHEN TRANSFERS ARE FRAUD?

In September 2016, the former mayor and finance director of the City of Miami, FL, was convicted in federal court of defrauding investors. Their crime, according to prosecutors from the Securities and Exchange Commission (SEC), was that they improperly transferred money that had been committed to debt service in other funds into the City's General Fund. City officials argued those transfers were common and were necessary to bolster the City's financial position just before the credit rating agencies updated the city's rating.

SEC officials and the jury disagreed. In their view, those transfers misled investors into thinking the City was financially stronger than it really was. Shortly after the verdict, City officials began negotiating a financial settlement with the SEC.

See SEC complaint: <https://www.sec.gov/litigation/complaints/2013/comp-pr2013-130.pdf>

As we noted earlier, detailed information on every non-major fund can be found in the *Combining Statements of Revenues, Expenses, and Changes in Fund Balance*. Total Revenues reported in the "Other Governmental Funds" (\$15.8 million) previously are now reported in the combining statement for every non-major fund. We see that much of the revenue is reported in the Street fund (\$6.1 million), the Park Cumulative Reserve fund (\$1.6 million), and the Public Safety GO (\$1.6 million). There were no revenues reported in the permanent fund and transfers to the 2013 GO Bond and LIFT GO Bond fund were used to meet principal and interest payments on outstanding bonds. This is not unusual. General obligation bonds would be repaid with tax revenues. If there are no dedicated taxes, revenues would be to a bond fund to meet debt service obligations. This is a policy decision.

Combining Statement of Revenues, Expenditures, and Changes in Fund Balances
Other Governmental Funds
December 31, 2021

	Special Revenue Funds					Permanent Fund						
	Street	Park Cumulative Reserve	Drug Forfeitures	Fire Impact Fees	Public Safety Levy	Total Special Revenue Funds	Cemetery Endowment	2013 GO Bond	Lift GO Bond	Public Safety GO Bond	Total Debt Service Funds	Total Other Governmental Funds
REVENUES												
Taxes	\$ 5,002,944	\$ 163,463	\$ -	\$ -	\$ 5,137,364	\$ 10,303,771	\$ -	\$ -	\$ 1,000,000	\$ 1,616,386	\$ 2,616,386	\$ 12,920,156
Licenses and permits	116,047	-	-	-	-	116,047	-	-	-	-	-	116,047
Intergovernmental revenue	999,283	-	-	-	26,879	1,026,162	-	-	-	-	-	1,026,162
Charges for services	24,152	1,471,323	-	131,503	-	1,626,978	-	-	-	-	-	1,626,978
Fine and forfeitures	-	-	88,034	-	-	88,034	-	-	-	-	-	88,034
Other revenue	1,247	-	-	-	-	1,247	-	-	-	-	-	1,247
Total revenues	6,143,673	1,634,786	88,034	131,503	5,164,243	13,162,239	-	-	1,000,000	1,616,386	2,616,386	15,778,624
EXPENDITURES												
Current												
General government	-	-	-	-	925,885	925,885	-	-	-	-	-	925,885
Security	-	-	3,383	-	1,553,325	1,556,708	-	-	-	-	-	1,556,708
Transportation	2,522,019	-	-	-	-	2,522,019	-	-	-	-	-	2,522,019
Physical environment	-	-	-	-	-	-	-	-	-	-	-	-
Capital Outlay	-	-	-	-	291,819	291,819	-	-	-	-	-	291,819
Other expenditures	-	-	-	-	-	-	-	300	-	-	300	300
Debt service	-	-	-	-	-	-	-	-	-	-	-	-
Principal retirement	-	-	-	-	-	-	-	425,000	795,000	780,000	2,000,000	2,000,000
Interest	-	-	-	-	-	-	-	271,013	1,200,650	836,038	2,307,700	2,307,700
Total expenditures	2,522,019	-	3,383	-	2,771,029	5,296,432	-	696,313	1,995,650	1,616,038	4,308,000	9,604,432
Excess of revenues over (under) expenditures	3,621,654	1,634,786	84,651	131,503	2,393,214	7,865,807	-	(696,313)	(995,650)	348	(1,691,615)	6,174,192
OTHER FINANCING SOURCES (USES)												
Transfers in	-	-	-	-	-	-	-	696,313	995,650	-	1,691,963	1,691,963
Transfers out	(1,942,944)	(25,000)	-	-	(28,156)	(1,996,100)	-	-	-	-	-	(1,996,100)
Total other financing sources (uses)	(1,942,944)	(25,000)	-	-	(28,156)	(1,996,100)	-	696,313	995,650	-	1,691,963	(94,137)
Net change in fund balances	1,678,710	1,609,786	84,651	131,503	2,365,058	5,869,708	-	-	-	348	348	5,870,055
Fund balance - beginning	3,223,639	4,263,094	109,884	318,661	3,748,109	11,663,386	84,013	-	-	3,626	3,626	11,751,025
Fund balance - ending	\$ 4,902,348	\$ 5,872,879	\$ 194,535	\$ 450,164	\$ 6,113,168	\$ 17,533,093	\$ 84,013	\$ -	\$ -	\$ 3,974	\$ 3,974	\$ 17,621,081

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PROPRIETARY FUND STATEMENTS

Governments account for their *business-type activities* using the accrual basis of accounting. This is the same basis of accounting used to prepare government-wide statements. The proprietary fund statements disaggregate information reported under business-type activities by fund type. We rewrite the fundamental equation of accounting as follows

$$\text{Assets} + \text{Deferred Outflows} = \text{Liabilities} + \text{Deferred Inflows} + \text{Net Position}$$

STATEMENT OF NET POSITION

Governments report proprietary fund assets, liabilities, and net position in a *Statement of Net Position*. Proprietary fund statements draw a distinction between major and non-major proprietary funds. Bothell is unique in that it did not have any non-major proprietary funds. There are only three funds – Water, Sewer, and Storm and Surface Water.

Total assets in Water (\$25.9 million), Sewer (\$23.5 million), and Storm and Surface Water (\$42.2 million) add up to the total assets reported under *business-type activities* (\$91.5 million). Again, the difference between the government-wide statement of Net Position and the proprietary fund

Statement of Net Position is the detailed reporting of assets, liabilities, revenues, and expenses by fund type – Water, Sewer, and Storm and Surface Water.

The proprietary fund Statement of Net Position reports current assets (\$26.3 million) separately from non-current assets (\$65.2 million). Governments are not required to report current assets separately from their non-current assets in the government-wide statements, but that breakdown is required in the proprietary fund statements.

Like most local governments, revenue bonds make up a large proportion of liabilities (\$13.5 million). A large proportion of the city's proprietary fund liabilities are in the Storm and Street Water fund (\$10.9 million).

Like the government-wide Statement of Net Position, the proprietary fund Statement of Net Position classifies the position as either Net Investment in Capital Assets, Restricted Net Position, or Unrestricted Net Position.

- *Net Investment in Capital Assets* in the historical cost of capital improvements – net of depreciation – and debt associated with the acquisition, construction, or improvement of capital In the Water Fund, net investment in capital assets is equal to \$16,634,885 – i.e., Capital Assets not being depreciated plus capital assets being depreciated minus depreciation (\$19,670,033) minus the current portion of revenue bonds payable, net (\$183,345) minus non-current revenue bonds payable (\$2,851,803).
- The *restricted net position* represents assets restricted by a third party or law. Governments are frequently required to establish restricted reserve funds following a revenue bond issue to ensure payments occur on time and in full. Revenue bond reserve funds are often the lesser of (a) maximum annual debt service, (b) 125 percent of average annual debt service, or (c) 10 percent of original bond proceeds.
- The remainder is reported as the *unrestricted net position*. Each business-type activity reports a positive unrestricted net position.

Statement of Net Position
Proprietary Funds
December 31, 2021

	Business-Type Activities Enterprise Funds				Governmental Activities
	Water	Sewer	Storm & Surface Water	Total	Internal Service Funds
ASSETS					
Current assets					
Cash and cash equivalents	\$ 303,342	\$ 744,901	\$ 2,049,875	\$ 3,098,118	\$ 2,390,973
Investments	4,190,215	6,307,503	8,464,320	18,962,038	2,300,000
Accounts receivable	859,474	1,817,087	-	2,676,561	53,396
Due from other governments	357	56,256	211,575	268,188	5,522
Reserved assets:					
Deposit held in trust	-	-	-	-	277,395
Investment-revenue bond reserve	109,785	292,497	914,086	1,316,369	-
Total current assets	5,463,173	9,218,244	11,639,857	26,321,274	5,027,286
Non-current assets					
Net pension assets	724,367	547,655	1,303,964	2,575,986	538,766
Capital assets not being depreciated:					
Land	122,175	163,126	-	285,302	-
Right of way	-	-	1,935,868	1,935,868	-
Construction in progress	405,339	997,494	1,757,076	3,159,909	-
Capital assets being depreciated:					
Intangible assets	141,538	122,978	146,663	411,179	-
Buildings	2,729,301	3,513,086	2,304,125	8,546,512	35,285
Improvements other than buildings	29,514,840	17,760,228	36,850,875	84,125,944	1,042,450
Equipment	59,048	1,806,274	275,951	2,141,273	1,829,336
Vehicles	30,457	30,457	250,920	311,834	9,562,936
Less accumulated depreciation	(13,332,666)	(10,711,077)	(14,284,192)	(38,327,935)	(8,960,868)
Total non-current assets	20,394,400	14,230,221	30,541,250	65,165,871	4,047,905
Total assets	25,857,573	23,448,464	42,181,107	91,487,144	9,075,191
DEFERRED OUTFLOWS OF RESOURCES					
Deferred outflows - pension	80,511	64,930	152,126	297,567	55,324
Total deferred outflows of resources	80,511	64,930	152,126	297,567	55,324
LIABILITIES					
Current liabilities					
Accounts payable	355,435	28,875	174,040	558,349	59,031
Payroll payable	66,558	51,240	119,130	236,948	43,504
Compensated absences	87,001	86,807	111,987	285,795	42,112
Due to other governments	1,166	-	593	1,759	39,488
Interest payable	-	-	-	-	144,831
Current portion of loans payable	-	-	45,516	45,516	-
Current portion of revenue bonds payable, net	183,345	86,047	608,890	878,281	-
Total current liabilities	693,504	252,988	1,060,157	2,006,481	328,966
Non-current liabilities					
Loans payable	-	56,250	455,497	511,747	-
Revenue Bonds Payable, net	2,851,803	1,276,047	9,400,707	13,528,557	-
Unearned revenue	-	-	-	-	277,395
Total non-current liabilities	2,851,803	1,332,297	9,856,204	14,040,304	277,395
Total liabilities	3,545,307	1,585,285	10,916,361	16,046,785	606,361
DEFERRED INFLOWS OF RESOURCES					
Deferred inflows - advance grant	-	-	12,909	12,909	-
Deferred inflows - pension	678,978	515,295	1,223,171	2,417,444	502,186
Total deferred inflows of resources	678,978	515,295	1,236,080	2,430,353	502,186
NET POSITION					
Net investment in capital assets	16,634,885	12,264,222	18,726,676	47,625,783	3,509,139
Restricted for pension assets	125,900	97,290	220,010	443,200	91,904
Restricted for debt service	109,785	292,497	914,086	1,316,369	-
Unrestricted	4,843,229	8,758,806	10,320,020	23,922,054	4,420,925
Total net position	\$ 21,713,799	\$ 21,412,814	\$ 30,180,793	\$ 73,307,406	\$ 8,021,968

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Internal service funds are reported in the proprietary fund statements. They account for programs in government that serve other parts of the government. The city of Bothell has three internal service funds – Equipment Rental (Fleet), Self-Insurance, and Asset Replacement. Internal service funds are designed to be self-supporting. They bill the receiving department at rates intended to cover the costs of goods or services provided. Keep in mind that these funds are not reported in the government-wide statements, as internal service accounts cancel out once we aggregate governmental activities with proprietary activities.

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION

The proprietary fund *Statement of Revenues, Expenses, and Changes in Fund Net Position* presents a summary of revenues, expenses, and changes in net position in the proprietary fund statements by fund type. A couple of features here merit additional discussion.

First, you will notice that Proprietary Fund Statements draw a distinction between operating revenues and non-operating revenues (expenses). Charges for services (\$21.9 million) are reported under operating revenues. Note that the amount reported in the Statement of Revenues, Expenses,

and Changes in Net Position is the same as that reported under business-type activities as Charges for Services.

Business-type activities report a modest amount in operating grants and contributions (\$7,763) and capital grants and contributions (\$1.8 million). Operating grants and contributions are not reported as operating revenues; rather, they are reported as non-operating revenues. The capital grants and contributions are also reported as non-operating revenues, just below transfers out. Reporting operating and capital grants and contributions as non-operating revenues reflects the non-recurring nature of revenues. The capital grants are reported separately from operating grants to reflect the fact that these revenues are not part of general operations.

Statement of Revenues, Expenses, and Changes in Fund Net Position
Proprietary Funds
For the Year Ended December 31, 2021

	Business-Type Activities Enterprise Funds				Governmental Activities
	Water	Sewer	Storm & Surface Water	Total	Internal Service Funds
OPERATING REVENUES					
Charges for services	\$ 6,339,397	\$ 8,788,494	\$ 6,863,366	\$ 21,991,257	\$ 4,022,162
Other operating revenue	3,011	62,564	44,855	110,430	-
Total operating revenue	6,342,408	8,851,058	6,908,221	22,101,687	4,022,162
OPERATING EXPENSES					
Administrative and general	897,152	1,067,502	2,003,189	3,967,843	2,788,021
Purchased water	1,734,839	-	-	1,734,839	-
Metro service	-	4,480,487	-	4,480,487	-
Maintenance and operations	984,712	689,838	1,593,614	3,268,165	381,957
Customer accounts	200,068	199,591	-	399,659	-
Taxes	825,860	633,502	476,404	1,935,766	-
Depreciation	881,887	632,655	1,333,495	2,848,037	962,396
Total operating expenses	5,524,519	7,703,575	5,406,702	18,634,796	4,132,374
OPERATING INCOME (LOSS)	817,889	1,147,483	1,501,519	3,466,891	(110,213)
NON-OPERATING REVENUES (EXPENSES)					
Investment income	-	-	6,428	6,428	1,677,027
Intergovernmental revenue	241	198	7,324	7,763	3,906
Miscellaneous revenue	18,762	-	251,247	270,009	-
Proceeds from sale of capital assets including insurance recoveries	-	-	-	-	157,386
Gain (loss) on disposition of capital assets	-	-	-	-	(264,102)
Revenue bonds interest	(98,686)	(44,310)	(326,807)	(469,803)	(1,670,280)
Total non-operating revenue (expense)	(79,683)	(44,112)	(61,808)	(185,603)	(96,064)
INCOME (LOSS) BEFORE CONTRIBUTIONS AND TRANSFERS					
Transfers in	738,206	1,103,371	1,439,712	3,281,288	(206,276)
Transfers out	(78,134)	(73,909)	(256,222)	(408,265)	(1,230,487)
Capital contributions	382,712	289,043	1,094,538	1,766,293	-
CHANGE IN NET POSITION	1,042,784	1,318,505	2,278,028	4,639,317	912,897
Net position - beginning	20,671,015	20,094,310	27,902,765	68,668,090	7,109,071
Net position - ending	\$ 21,713,799	\$ 21,412,814	\$ 30,180,793	\$ 73,307,406	\$ 8,021,968

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FIDUCIARY FUNDS STATEMENTS

We’ve covered governmental, proprietary, and internal service funds. The final type of fund you’ll see on a government’s financial statements is fiduciary funds. *Fiduciary funds* account for resources held for the benefit of parties outside of the reporting government. Fiduciary funds are not reported in the government-wide financial statements because the resources of those funds are not available to support the government’s own programs.

Most fiduciary funds relate to retiree benefits (i.e., pension and OPEB). Different plans are managed

in quite different ways. Some are managed at the state level, and beneficiaries are not only state employees but also employees of local governments that participate in state-sponsored or state-administered plans. Some governments are “self-funded,” meaning they manage a plan whose members come only from their government. In Washington, most public employee pension and OPEB plans are managed by the state. For that reason, the fiduciary fund statements for the State of Washington are extensive, as they account for all retirement plans administered and managed by the state.

The City of Bothell does not report any assets held on behalf of its employees. In other words, retirement benefits for current and former employees of the city of Bothell are administered by the state. The city does not report any employee retirement benefit funds in its fiduciary funds. Rather the city reports two trust funds a Private-Purpose Trust Fund and a Custodial Fund. The Private Purpose Trust funds include proceeds held on behalf of beneficiaries in the Court Bail Bond Trust and Court Restitution Trust. The Custodial Fund reports court collection fees on behalf of King County and the state of Washington.

Statement of Net Position
Fiduciary Funds
For the Year Ended December 31, 2021

	Private-Purpose Trust Funds	Custodial Fund	Total
ASSETS			
Cash and cash equivalents	\$ 38,758	\$ 32,255	\$ 71,013
Total assets	38,758	32,255	71,013
DEFERRED OUTFLOWS OF RESOURCES			
Total deferred outflows of resources	-	-	-
LIABILITIES			
Accounts payable	-	32,143	32,143
Total liabilities	-	32,143	32,143
DEFERRED INFLOWS OF RESOURCES			
Total deferred inflows of resources	-	-	-
NET POSITION			
Restricted for:			
Individuals, organizations and other governments	38,758	112	38,870
Total net position	\$ 38,758	\$ 112	\$ 38,870

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Governments also produce a *Statement of Changes in Fiduciary Net Position*. This statement is similar to an income statement. Instead of revenues and expenditures, it identifies *additions* and *deductions* to the fiduciary funds. Additions reflect the increase in assets – deductions account for the decrease in assets. For the city of Bothell, additions in the fiduciary fund statements included payments to the Court Bail Bond Trust, the Court Restitution Trust, and fees collected on behalf of King County and the state of Washington. Deductions reported payments in each of these accounts.

Statement of Changes in Net Position
Fiduciary Funds
For the Year Ended December 31, 2021

	Private-Purpose Trust Funds	Custodial Fund	Total
ADDITIONS			
Court bail bond/restitution trust	\$ 82,005	\$ -	\$ 82,005
Fees collections for other governments	-	186,271	186,271
Total additions	<u>82,005</u>	<u>186,271</u>	<u>268,276</u>
DEDUCTIONS			
Payments of Court bail bond/restitutions	84,262	-	84,262
Payments of fee to other governments	-	186,918	186,918
Total deductions	<u>84,262</u>	<u>186,918</u>	<u>271,180</u>
Net increase (decrease) in fiduciary net position	(2,258)	(647)	(2,905)
Net position - beginning	41,015	759	41,774
Net position - ending	<u><u>\$ 38,758</u></u>	<u><u>\$ 112</u></u>	<u><u>\$ 38,870</u></u>

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FEDERAL GOVERNMENT FINANCIAL REPORTING

The federal government does, in fact, prepare a set of audited financial statements known as the Financial Report of the United States Government. A division of the U.S. Treasury known as the Bureau of the Fiscal Service prepares this report according to a set of accounting principles developed by the Federal Accounting Standards Advisory Board (FASAB). Those principles are similar to modified accrual accounting, focusing on financial resources and fiscal accountability. They also incorporate some recognition concepts that speak to the unique nature of federal appropriations and budget authority. The Government Accountability Office (GAO) then audits those statements according to those standards.

The federal government has never received an audit opinion on these financial statements. GAO has yet to issue an opinion due to several material weaknesses in internal controls, especially at the Department of Defense (DOD). That said, the federal government has substantially improved its financial reporting processes. Today almost all of the 24 major cabinet agencies have received an unqualified audit opinion, and the DOD has convened a high-level task force to address its internal control shortcomings.

FINANCIAL STATEMENT ANALYSIS

FINANCIAL STATEMENT ANALYSIS: “HOW ARE WE DOING?”

Financial statement analysis informs a wide variety of strategic management questions, including:

- What is this organization’s overall financial position? Is it liquid? Profitable? Solvent?
- How does this organization’s financial position compare to its peer organizations?
- How much debt or other long-term liabilities can this organization afford?
- How can this organization adjust its operations and policies to strengthen its financial position?

On March 22, 2014, the side of a hill near the town of Oso, Washington, gave out after three days of relentless rainfall. A massive landslide followed, with mud and debris covering more than a square mile. Forty-three people were killed when the slide engulfed their homes.

In the days that followed, more than 600 personnel participated in search and recovery operations. They rescued eight people from the mud and evacuated more than 100 others to safety. Most of the rescue personnel came from the four rural Snohomish County fire districts surrounding Oso.

Minutes after hearing of the slide, staff at the Washington State Office of Financial Management (OFM) – the governor’s budget office – made two critical phone calls. Earlier that week, they had reviewed some data on the financial health of local special districts across the state. They observed that rural fire districts in the counties north of greater Seattle showed signs of acute fiscal stress. Those districts had seen huge growth in property tax collections during the real estate boom of the 2000s. But since the real estate crisis of 2007-2009, those revenues had fallen precipitously. Many of these districts had laid off staff, cut back on specialized training, and back-filled shifts with volunteer firefighters.

So, moments after hearing of the slide, OFM staff called the fire chiefs at two of the most financially stressed Snohomish County fire districts. Their message to those chiefs was simple: send your people. OFM agreed to reimburse the districts from state or federal emergency management funds if needed. In turn, personnel from two of those districts were among the first on the scene and were responsible for three of the eight life-saving rescues.

A few weeks later, the chiefs of both those districts acknowledged that had OFM not called, they would not have sent their personnel. Both districts were so financially stressed that they could not have afforded the overtime wages and other expenses they’d have incurred to participate in the rescue operations.

Financial condition matters. It shapes how a public organization thinks about its mission and capacity. In the case of the Oso mudslide, it was the focal point for some life-saving decisions. That is why all aspiring public servants need to know how to evaluate financial statements and measure, manage, and improve their organization's financial position.

LEARNING OBJECTIVES

After reading this chapter, you should be able to:

- Compute and interpret ratios that describe liquidity, profitability, and solvency. Contrast how those ratios mean slightly different things across the government, non-profit, and for-profit sectors.
- Understand the typical strategies organizations employ to improve their liquidity, profitability, and solvency.
- Contrast short-term solvency with long-term solvency, particularly for governments.

WHAT IS FINANCIAL POSITION?

Financial position is a public organization's ability to accomplish its mission now and in the future. When stakeholders ask, "*How are we doing financially?*" the answer should reflect that organization's financial position.

An organization's financial position has three main components:

1. **Liquidity.** Does the organization have liquid resources to cover its near-term liabilities?
2. **Profitability.** Do the organization's revenues cover its operating expenses?
3. **Solvency.** Can the organization generate enough resources to cover its near-term and long-term liabilities?

In the previous chapter, you learned how to extract information about an organization's financial position from its balance sheet. For example, are most assets liquid (e.g., cash and marketable securities), or does the organization have assets that are more difficult to convert to cash (e.g., receivables, inventory, or prepaid expenses)?

The balance sheet also tells us a lot about solvency, namely if the organization has a lot of long-term liabilities (e.g., long-term debt or pension liabilities). Long-term liabilities mean the organization will have to divert some of its resources to meet those obligations, which can mean fewer resources to invest in its mission. To be clear, there are times when an organization can and should take on long-term liabilities in pursuit of its mission. Sometimes it makes sense to borrow and invest in a new facility that allows the organization to serve its clients effectively. Pensions and retiree health care benefits are an important employee recruitment and retention tool, even though offering current and future employees these benefits could result in a long-term obligation.

To learn about profitability, we typically look to the income statement. Recall that if an organization's

revenues exceed its expenses, its net assets will grow. The income statement clarifies the organization's key sources of revenues, which revenues are growing, and whether those revenues cover program and administrative expenses. The income statement also shows depreciation, bad debt expenses, and other expenses that reduce net assets but do not impact cash. These are all solvency considerations.

While financial ratios can provide useful metrics, always start with a quick review of the financial statements. Ideally, the financial statements you are working with should report on the organization's operating and financial position for at least two financial periods – though that is not always the case. Keep in mind that funding agencies and financial analysts need access to at least four, if not five years, of financial data. A review of the trends should inform your interpretation of the ratios.

A review of the *Statement of Financial Position* (or Statement of Net Position) can be guided by the following questions:

- *Assets*: How have the assets changed? What proportion of assets are current? How much is reported under cash and cash equivalents? How much is reported under property plant and equipment, net of depreciation? Were there any new investments in property, plant, and equipment (review note on fixed assets)? How much is reported in investments? What proportion of investments are restricted? Have investments changed significantly, and was this the result of market gains and investment income, a capital campaign, or transfers from cash? How much more or less is the organization reporting in receivables, prepaid expenses, or inventory? Have changes in current assets had a negative or positive impact on cash flows?
- *Liabilities*: How have the liabilities changed? What proportion of liabilities is the result of operations? What proportion of liabilities is current? What proportion of liabilities is the result of financing activities? Of that, how much is in the form of a short-term loan or a line of credit? Is the organization subject to loan covenants or restrictions, and are these disclosed in the notes to the financial statements? Are there any contingent liabilities because of recent lawsuits, and what is the probable liability?
- *Net Assets*: What proportion is reported as net assets without donor restrictions? What proportion is reported as net assets with donor restrictions? Of net assets with donor restrictions, what proportion is reported as permanently restricted (review notes on Endowment funds)?

Similar questions can guide your review of the *Statement of Activities*:

- *Revenues*: What are the major sources of revenues? Were there significant changes in operating revenues? Of total revenues, what percent is “with donor restrictions”? What proportion is contributed versus earned (e.g., fee for services, government contracts)? How much does the organization report as foundation grants? Corporate gifts? Is the organization susceptible to changes in governmental agency or foundation funding priorities?
- *Expenses*: How much did the organization spend on programs? How much did the organization spend on administration? Fundraising? Were there significant changes in the level of spending? What proportion of our expenses are personnel costs? Have personnel costs changed? How much did the organization report in depreciation and amortization? Are there

other fixed costs that limit budget flexibility?

FINANCIAL STATEMENT RATIOS

The purpose of accounting is to help organizations make better financial decisions. *Financial statement analysis* is the process of analyzing an organization's financial statements to produce new information to inform those decisions. Public organizations make dozens of crucial decisions every day: Should we expand a program? Should we lease or buy a new building? Should we move cash into longer-term investments? Should we accept terms in a contract with a government agency? Should we accept a grant with restrictions from a foundation? Should we, as a funding agency, fund a particular organization?

These decisions can be informed by financial statement analysis. An organization should only expand if its existing programs are profitable. It should invest in new property or equipment once it understands how existing fixed asset costs contribute to or detract from its net position. It should move cash into less liquid investments once it knows the organization has sufficient liquid resources to cover its operating expenses.

To answer these questions, we need metrics that demonstrate an organization's liquidity, profitability, and solvency. We turn to financial ratios (sometimes called financial statement ratios) for those metrics. Financial ratios are calculations derived from information included in the financial statements. Each ratio illustrates one dimension of an organization's overall financial health. Analysts who evaluate public organizations' financial statements employ dozens of different financial ratios. However, the way they use ratios will be unique to their needs. For example, the criteria used by financial institutions (or credit rating agencies) will differ from those used by funding agencies. In other words, context and goals matter.

Therefore, a word of caution is necessary when it comes to financial ratios. For many, financial statement ratios objectively assess the organization's financial position and overall performance. However, when applied incorrectly, they can lead to improper allocation of resources within an organization. For example, focusing on profit maximization, particularly on programs that do not align with the organization's core values or mission, could lead to mission creep.

Relatedly, criteria used to assess the organization's financial health should not be the sole criteria used to determine a non-profit's eligibility for a grant or contract. As you'll see below, financial ratios are objective measures of financial position and performance that do not incorporate an organization's proven track record in service delivery. Financial ratios emphasize the organization's financial strengths and do not address the organization's effectiveness. Financial ratios do not relay the organization's unique challenges, or the efforts management and staff have undertaken to address those challenges. In fact, the widespread use of ratios has resulted in widespread inequity in philanthropic giving. Research shows that Black-led organizations receive less funding and are more likely to receive funding with restrictions when compared to peer white-led organizations. As a result, these organizations report low cash reserves, frequently report operating deficits, and often report fewer net assets without donor restrictions. Continued use of financial ratios as criteria for funding organizations perpetuates the cycle – well-funded organizations continue to receive funding without

restrictions. In contrast, smaller organizations in poor financial health receive less or restricted funding.

We apply a similar word of caution when using ratios to assess the financial health of governments. A careful review of budget documents or related socio-economic or legal environments would give users a better understanding of why the government reported a deficit or high debt burden. And as we discuss later in this chapter, governments need not be profitable to continue operations.

So, while we endorse the use of financial ratios, we recognize there are limits to their usability and encourage users to contextualize their analysis to the organization, industry, and region of operations.

ADDRESSING RACIAL BIAS IN PHILANTHROPY AND GRANTMAKING

Philanthropy has proven itself as a powerful mechanism for working toward a more equitable society by challenging oppression and seeking to ensure social, economic, and political change (Powell, 2015). But biases based on race, gender, and other factors are still a real problem in the sector, often in the form of implicit bias. Implicit bias refers to the attitudes or stereotypes that affect our understanding, actions, and decisions in an unconscious manner. These biases, which encompass favorable and unfavorable assessments, are activated involuntarily and without an individual's awareness or intentional control.

Implicit bias in philanthropy affects not just which groups get funded but also who sits on the boards of philanthropic organizations, how grantmaking foundations set priorities, how decisions are made, who makes those decisions, and even who gets hired (Powell, 2015). A D5Coalition 2016 report found that 92 percent of foundation CEOs were white, 83 percent of full-time executive staff were white, and 68 percent of program staff were white. Studies have shown that three-quarters of white people have entirely white social networks, a factor that further excludes organizations led by people of color from philanthropic networks (Dorsey et al., 2020). The D5Coalition report also found that only eight percent of grants were directed to organizations that served diverse communities.

A 2020 study (completed by Echoing Green and Bridgspan) found that Black-led organizations were more likely to receive less funding, receive restricted grants, and were required to meet rigorous reporting requirements. Undoubtedly, the lack of unrestricted support reflects a lack of trust in organizations led by people of color (Dorsey et al., 2020). Over time, disparities in revenue and restrictions result in few net resources that do not have donor restrictions. Data shows that Black-led organizations reported a net asset position without donor restrictions that was 76 percent less than white-led organizations. Additionally, data shows organizations led by Black women consistently receive less support than either Black men or white women. Disparities persist even considering factors like issue area, education level, and gender.

Financial metrics (e.g., revenue growth, demonstrated operating performance, and accumulated reserves) are frequently used to determine organizations with the "capacity" to manage grants, discounting the value of the organization's work. **Using financial health criteria to determine who receives funding perpetuates a vicious cycle**, further depriving chronically underfunded organizations that have the potential to do good work!

So, what should funders do? Below are some recommendations based on our review of the existing research. Our list is not comprehensive – we have included an extensive list of readings at the end of this section.

- **Focus on organizational strengths.** Assess the organization's proposals based on its ability to do the work, not trends in revenues or whether the non-profit has reserves or an endowment. Allow for a narrative contextualizing the non-profit's operating environment and financial history. Understand all the financial and non-financial resources the organization mobilizes to achieve its mission and endeavor to value the work being performed. Funders should provide unrestricted capacity-building grants to strengthen organizational leadership and management and eliminate matching grant requirements, as these requirements marginalize organizations that lack the fundraising capacity and unconsciously steer funding to well-resourced organizations with accumulated resources or access to fundraising networks (Nonprofit Finance Fund, 2019).
- **Cover full costs.** Recognizing overhead costs is essential for the proper function of any organization. Smaller organizations do not benefit from economies of scale and, as a result, report higher-than-average overhead costs

(median ratio of 20 percent). Larger organizations, especially those with a regional presence or brand recognition, have the capacity to raise public support from individual donors. In contrast, smaller organizations do not have a large or wealthy donor base or the capacity to create one. Understand operational context and challenges. For example, non-profits that rely on government contracts are more likely to be chronically underfunded, as governments rarely cover overhead costs. To that end, funders should consider providing capacity-building grants, as these investments position the organization to deliver higher-quality services beyond the life of the grant.

- **Shift focus from reporting to engagement.** Evaluate whether reporting requirements are grounded in organizations demonstrating results or distrust of leaders. Funders should streamline grant application processes and eliminate redundancies in reporting. Where possible, shift the funding model away from restricted annual grant awards to unrestricted multi-year grants, demonstrating the funder's trust and investment in the organization. Engage with grantees in tangible ways other than grant reports and develop relationships that are not contingent on funding. Build grantee capacity by providing additional funding to smaller organizations to meet reporting requirements and create reporting mechanisms that result in program metrics relevant to both the grantor and grantee.
- **Give more – much more!** Foundations consistently use the five percent payout rule as a maximum level of giving, even though the tax law established the five percent payout rule as the minimum. Data shows that even though foundation wealth has nearly doubled since the Great Recession, the level of giving did not change significantly over the period. A philosophical shift that puts “spending decisions within the context of mission” rather than “mission in the context of available resources” shifts the focus away from wealth accumulation and perpetuity of foundations to investing in mission-aligned priority areas at levels that would lead to sustained changes. Additionally, foundations should diversify their grantee portfolio. They should invest in smaller organizations led by Black, Indigenous, or people of color that work in communities that face funding disparities.
- **Make diversity, equity, and inclusion a top priority.** The world of philanthropy relies on relationships. Whom you know and who knows you matter! Philanthropic organizations committed to social, economic, and political change lack the lived experience of people of color in low-income communities. Funding organizations should prioritize diversifying their organization, from the non-profit board to the program staff. They should expand their grantee sourcing mechanisms and intentionally reach out to smaller grassroots organizations whose programming and values align with foundation priorities. Finally, they need to be accountable to themselves and the community they serve. To that end, they should report on their diversity, equity, and inclusion goals, benchmarks, and progress.

Our knowledge of implicit bias in philanthropy benefited from the work of many, including Cheryl Dorsey, Jeff Bradach and Peter Kim. (2020). Racial Equity and Philanthropy: Disparities in Funding for Leaders of Color Leave Impact on the Table (Echoing Green and The Bridgspan Group), D5Coalition (2016) "State of the Work: Stories from the Movement to Advance Diversity, Equity, and Inclusion," John A Powell (2015) "Implicit Bias and its Role in Philanthropy and Grantmaking" and Non-profit Finance Fund (2019) "Addressing Racial Biased Financial Analysis."

The first table lists a set of *liquidity ratios*. Recall that **liquidity is the ease with which an asset can be converted to cash with minimal loss in value**. Liquidity ratios assess liquid assets that can cover the organization's obligations or day-to-day expenses. The numerator in these ratios measures liquid resources – either current assets or a specific type of current asset (e.g., cash and cash equivalents, receivables, etc.). The denominator is a measure of existing obligations – either current liabilities or average daily cash expenses. To estimate average daily expenses, we take total expenses and deduct expenses like depreciation, amortization, and bad debt expense that do not require an outflow of liquid resources. Our estimate of cash expenses is then divided by 365 days to produce a rough measure of average daily cash spending.

For governments, the focus is on the General Fund. Recall that the General Fund accounts for unrestricted resources or resources that are not required to be accounted for in other funds. **The**

unassigned fund balance is the most closely watched number in governmental accounting. It reports on the government’s unrestricted resources.

Ratio	What it Tells Us	LIQUIDITY RATIOS		
		Non-Profit	Government	For-Profit/Hybrid
Current Ratio	Will near-term assets cover near-term obligations?	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	$\frac{\text{General Fund Assets}}{\text{General Fund Liabilities}}$	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$
	Rule of Thumb: >2			
Quick Ratio	Will the most liquid assets cover near-term obligations?	$\frac{\text{Cash + Investments + Receivables}}{\text{Current Liabilities}}$		$\frac{(\text{Cash + Investments} + \text{Receivables})}{\text{Current Liabilities}}$
	Rule of Thumb: >1			
Cash Ratio	Will cash and investments cover near-term obligations?	$\frac{\text{Cash + Investments}}{\text{Current Liabilities}}$	$\frac{\text{General Fund Cash + General Fund Investments}}{\text{General Fund Liabilities}}$	$\frac{(\text{Cash + Investments})}{\text{Current Liabilities}}$
	Rule of Thumb: >1			
Days of Cash on Hand	How many days of cash do we have?	$\frac{\text{Cash + Investments}}{(\frac{\text{Total Expenses - Depreciation}}{365 \text{ Days}} - \text{Bad Debt Expense})}$		$\frac{\text{Cash + Investments}}{(\frac{\text{Total Expenses - Depreciation}}{365 \text{ Days}} - \text{Bad Debt Expense})}$
	Rule of Thumb: >90 days			
Days of Liquid Net Assets	How many days of liquid net resources do we have?	$\frac{(\text{Net Assets Without Restrictions} - \text{Fixed Assets, Net of Depreciation})}{(\frac{\text{Total Expenses - Depreciation}}{365 \text{ Days}} - \text{Bad Debt Expense})}$		$\frac{(\text{Net Assets Without Restrictions} - \text{Fixed Assets, Net of Depreciation})}{(\frac{\text{Total Expenses - Depreciation}}{365 \text{ Days}} - \text{Bad Debt Expense})}$
	Rule of Thumb: >180 days			
Receivables Turnover	How long does it take us collect receivables?	$\frac{\text{Receivables}}{(\text{Revenues}/365 \text{ days})}$		$\frac{\text{Receivables}}{(\text{Revenues}/365 \text{ days})}$
	Rule of Thumb: <60 days			
Short-Run Financial Position	How much in unrestricted resources do we have as a percent of our revenues?		$\frac{\text{Unassigned General Fund Balance}}{\text{General Fund Revenues}}$	
	Rule of Thumb: >5%			

LIQUIDITY AND AVAILABILITY OF FINANCIAL ASSETS DISCLOSURE

FASB Accounting Standards Update No. 2016-14 requires non-profits to disclose qualitative (narrative) and quantitative (numeric) information about their liquidity and availability. According to the standard, the most basic measure of liquidity is the “availability of resources to meet cash needs for expenses within one year of the date of the statement of financial position.” The availability of a financial asset may be affected by (1) its nature, (2) external limits imposed by donors, grantors, laws, and contracts with others, and (3) internal limits imposed by the governing board. Qualitative information communicates how the non-profit entity manages its liquid resources to meet cash needs for expenses. In contrast, quantitative information communicates the availability of the non-profit’s financial assets to meet cash needs for expenses – all within a year of the balance sheet date.

Although common sense tells us that having more assets available for use without limitations allows for greater flexibility to meet unforeseen financial circumstances, it does not immediately follow that a not-for-profit organization that shows a relatively small portion of its assets as “available for general expenditure” is experiencing financial difficulty.

Non-profits routinely use assets received with donor restrictions in ongoing programmatic and operational activities. In those

cases, assets that appear to have limitations are, in fact, being put to immediate use paying for day-to-day operations. The narrative disclosure should give financial statement users insight into the full range of assets available for use.

Non-profits may also describe established operating reserve policies, how they manage cash based on major receivables cycles, and the availability and use of lines of credit. When contemplating liquidity disclosures, NFPs should:

- Consider the message they want to convey to stakeholders: Does your organization have ample resources to fund activities over the next 12 months? If yes – you want to make that clear in the disclosure. You may also want to discuss your policy for dealing with excess revenues (e.g., the board designates a certain percentage of excess budgeted funds to be added to the organization’s operating reserves). If your organization struggles to maintain sufficient resources to cover expenses, you may want to disclose your action plan for covering those expenses. Perhaps you have lines of credit that could be drawn upon if needed, or maybe you are expecting a large grant that will fund a significant portion of your expenses.
- Review its current procedures around board designation of net assets: What are the board’s current procedures for identifying and designating net assets – are they formally documented, or are amounts designated by the board on an ad-hoc basis? Considering the board’s awareness of management’s designations is important, given the new standard’s emphasis on board designation of net assets. In addition to reviewing current procedures, this may be a good time for the board to revisit existing board designations to determine if they still make sense and determine if any new policies will be required.
- Adopt an operating reserve policy if your organization doesn’t already have one. This policy would document (a) what the organization considers an appropriate level of reserves, (b) how the reserves will be built, and (c) the steps to follow if the reserves fall below the set level.
- Decide on the best presentation approach for your organization. The format of the new liquidity disclosures will depend on the type of non-profit, the relative liquidity of the organization’s resources, donor-imposed restrictions on those resources, internal board designations on resources, and so on.

The following reflects Treehouse’s availability of financial assets as of the consolidated statement of financial position date. Financial assets are reduced by the amounts not available for general use within one year of the consolidated statement of financial position date because of contractual or donor-imposed restrictions or internal designations. Internal designations can be changed based on board approval.

Financial assets, at year-end	
Cash and cash equivalents	\$ 4,430,208
Investments	8,352,346
Contracts and other receivables	3,528,538
Pledges receivable	1,325,881
	<u>17,636,973</u>
Less those unavailable for general expenditures within one year	
Due to donor purpose restrictions	-
Due to donor time restrictions	380,000
Due to endowment purpose restriction	4,403,995
	<u>4,783,995</u>
Financial assets available to meet cash needs for general expenditures within one year	<u><u>\$ 12,852,978</u></u>

The non-profit may also consider adding or augmenting other disclosures. For example, suppose in your liquidity disclosures, you choose to break out the availability of promises to give into those that are donor-restricted and those that are not. In that case, consider whether providing the same breakout in your pledges receivable disclosure would be useful to the users of your financial statements.

We drew heavily from two articles prepared by the American Institute of CPAs (AICPA), including “The New Liquidity and Availability Disclosure and Going Concern Issues” and “Steps You Can Take Now to Create Exceptional Liquidity Disclosures.”

Profitability is an intuitive measure derived from changes in net assets (or change in net position). Recall that net assets increase when revenues exceed expenses – and vice versa.

The *operating margin* speaks to profitability in the organization’s core operations (i.e., change in net assets without donor restrictions). Gross margin (sometimes called margin) is the difference between net sales and cost of goods sold. Industries like retail clothing have extraordinarily tight margins, meaning the price often exceeds unit costs by a percent or two. Low-margin businesses must be “high volume,” meaning they must sell a lot of products to be profitable. Professional services like accounting, tax consulting, and equipment leasing are “high margin,” meaning the price charged far exceeds the unit cost, sometimes by orders of magnitude. High-margin industries tend to have barriers to entry. They require highly trained professionals, expensive equipment, or other significant up-front investments.

The *total margin* is a broader measure of profitability across the entire organization. For non-profits, the total margin accounts for all activities reported in the year, regardless of the restriction. For governments, the total margin incorporates the change in the net position of business-type activities. For for-profit or hybrid organizations, total margin accounts for all expenses before interest, taxes, depreciation, and amortization, frequently referred to as “EBITDA” (*e-bit-dah*).

There are caveats to the total margin ratio – particularly for governments and non-profit organizations. Organizations that receive funding with donor restrictions are more likely to report a total margin ratio greater than their operating margin. As noted in Chapter 2, change in net assets has two components – net assets without donor restrictions and net assets with donor restrictions. The total margin includes the latter, even though the organization will need to expend those resources at a future date or are restricted in perpetuity. Using the organization’s total margin ratio would incorrectly signal the non-profit’s profitability.

PROFITABILITY RATIOS

Ratio	What it Tells Us	Non-Profit	Government	For-Profit/Hybrid
Operating Margin	Do operating revenues cover operating expenses? Rule of Thumb: Positive	$\frac{\text{Change in Net Assets Without Donor Restrictions Revenues Without Donor Restrictions}}{\text{Total Revenue}}$	$\left(\frac{\text{Net Revenue (Expense)}_{\text{Governmental Activities}}}{\text{Total Revenues}_{\text{Governmental Activities}}} \right) \times -1$	$\frac{(\text{Sales} - \text{Cost of Goods Sold})}{\text{Sales}}$
	Total Margin Do total revenues exceed total expenses? Rule of Thumb: Positive	$\frac{\text{Change in Net Assets}}{\text{Total Revenue}}$	$\frac{(\text{Change in Net Position})_{\text{Primary Government}}}{(\text{Total Revenue})_{\text{Primary Government}}}$	$\frac{\text{Earnings before Interest, Taxes, Depreciation, and Amortization (EBITDA)}}{\text{Total Revenue}}$
Return on Assets	How well does management leverage its assets to generate profits? Rule of Thumb: Positive	$\frac{\text{Change in Net Assets}}{\text{Total Assets}}$		$\frac{\text{Earnings Before Interest and Taxes}}{\text{Total Assets}}$
	Return on Investments How well does management leverage its investments to generate income? Rule of Thumb: Positive	$\frac{\text{Investment Gain (Loss)}}{\text{Total Investments}}$		
Return on Equity or Net Asset Growth	What is the return on shareholders investments? Rule of Thumb: Positive	$\frac{\text{Change in Net Assets Without Donor Restrictions Net Assets Without Donor Restrictions}_{t-1}}{\text{Net Assets Without Donor Restrictions}_{t-1}}$	$\frac{\text{Change in Governmental Activities Net Position Net Position, Governmental Activities}_{t-1}}{\text{Governmental Activities}_{t-1}}$	$\frac{\text{Net Income}}{\text{Equity}}$
	Own Source Revenue How much does this organization depend on support from other governments? Rule of Thumb: < 10%		$\frac{\text{Primary Govt. Contributions}}{\text{Primary Govt. Revenues}}$	
Inventory Turnover	How long does it take us sell inventory? Rule of Thumb: <60 days			$\frac{\text{Inventory}}{(\text{Cost of Goods Sold} / 365 \text{ days})}$

For governments, the total margin ratio would include the change in the net position of their business-type activities. While business-type activities are self-sustaining, the profits cannot be used to subsidize the government’s core operations without legislative approval or a voter referendum. Consider the case of the City of Detroit when it filed for bankruptcy protection in 2013. City officials sought to transfer funds from its business-type activities (mainly funds in water and sewer) to the General Fund. Bondholders, secured with revenues from water and sewer services (i.e., business-type activities) sued and successfully prevented the transfer of funds to the General Fund, arguing resources are not fungible. Changes in law, contract, and administrative procedures would be required before resources are transferred from one fund to another.

Profitability measures are less salient for governments because governments need not be profitable to continue operating. Governments have the legal authority and monopolistic advantages that non-profits and for-profits do not. Governments can bolster their financial position by raising taxes or imposing fees. That’s why profitability measures for government are focused on not just the change in net position but the share of revenues derived from general revenues versus grants or contributions.

Solvency measures speak to where the organization gets its resources. Revenues – earned or contributed – pay for regular programming and operating expenses. Capital – loans and mortgages – are how an organization acquires its assets. If a non-profit depends too much on unpredictable or volatile donor revenues, that’s a potential solvency concern. The same is true of revenues from governments. Intergovernmental grants and contracts can disappear quickly if the government changes its fiscal policies and priorities.