Public Health Departments and Non-Profit Organizations (NPO's)

Financial management can be viewed as all the activities entailed in maximizing profit and minimizing financial risk. This means that leaders of a health care organization endeavor to earn a profit in order to maintain stability and to ensure the financial resources necessary to continue the organization's mission, while at the same time reducing or controlling factors that can cause financial instability. Understanding the nature of profit is important for two reasons:

1. First, profit is a measure of how efficiently an organization operates in relation to the revenues it generates.
2. Second, profit can indicate the cost of doing business in the future. In other words, a health care organization needs to generate profit in order to have the financial resources for expansion to serve new populations and illnesses.

One of the most distinctive characteristics of the health care provider sector in the health care industry is the nonprofit nature of most of the organizations. Although there are numerous for-profit facilities and physician clinics, the majority of hospitals, nursing homes, and large integrated delivery systems (such as the Mayo Clinic, Cleveland Clinic, Group Health, and the Kaiser Health System, to name a few) are organized as nonprofit organizations.

When considering health care finance, it's important to understand the similarities and differences in the for-profit and nonprofit paradigms.

For-Profit Paradigm

The main objective of most for-profit firms is to earn profits that are distributed to the owners or to reinvest in the organization for long-term benefit to the owners.

The for-profit paradigm begins with the following basic economic equation: **profit = total revenue – total expenses.**

There are three possibilities when comparing total revenue with total expenses:

Table 1: Possible outcomes for comparing total revenue and total expenses

1. Total revenue is greater than total expenses = a profit

2. Total revenue is equal to total expenses = a break-even situation

3. Total revenue is less than total expenses = a loss

Suppose that a local Wal-Mart store had $100 million in revenues and $90 million in expenses. The profit would be $10 million. Suppose the store had $100 million in revenues and $100 million in expenses. The difference between total revenue and total expenses would be zero, making this a break-even situation. If the store had total revenue of $90 million and total expenses of $100 million, it would have a loss of $10 million.

In addition to understanding these three possibilities when comparing total revenue with total expenses, it's also important to understand the magnitude of the loss or profit in order to appreciate the impact that the operating results have on the financial stability of an organization. You can plug other numbers into the equations in table 4.1 to simulate different magnitudes of profit and losses.

The for-profit paradigm is important for a variety of reasons. It provides an incentive for efficiency (efficiency means getting the most for the least); because a small decrease in expenses can result in a large increase in profits. Returning to the equations in table 4.1, when the total revenue is $100 million and the total expenses are $90 million, the profit is $10 million. Using the same revenue of $100 million, let’s assume that the expenses are $85.5 million. This reduction in expenses is a 5% improvement in efficiency (from $90 million in expenses to $85.5 million in expenses), but look at the impact on the profit: a 45% increase in profit from $10 million to $14.5 million.

Distinctions between For-Profit and Nonprofit Paradigms

Up to this point, all the concepts under the for-profit paradigm apply in important ways to nonprofit organizations. In other words, nonprofit organizations need to maximize profit and minimize risk in the same manner and for the same reasons that for-profit organizations do. However, there are important distinctions between for-profit and nonprofit paradigms that must be observed.

Recall how the profit for our first hypothetical Wal-Mart store was presented. Now let’s look at Central Valley Hospital, a hypothetical nonprofit hospital with the same profile of revenues and expenses as the Wal-Mart store. The “bottom line” for both the Wal-Mart store and Central Valley Hospital is $10 million. However, this bottom line has different names depending on whether the organization is a for-profit or nonprofit entity. In a for-profit entity, the $10 million would be called a profit. However, in a nonprofit entity, the $10 million would be known as an “excess of revenues over expenses” or by such terms as "surplus" or "net income." The important thing to remember is that the calculation of the bottom line for a for-profit and nonprofit organization is the same, but the name is different. This underscores the fact that the distinction between for-profit and nonprofit organizations is a legal distinction, because many of the financial features are similar.

Table 2: Simulation of possible outcomes for nonprofit organizations: surplus, breakeven, and loss

	Surplus	Breakeven	Loss
Total revenue	$100,000,000	$100,000,000	$90,000,000
Total expenses	$90,000,000	$100,000,000	$100,000,000
Outcome	$10,000,000	$0	-$10,000,000

There is also an important difference in the possible uses of a profit or surplus. In a for-profit organization, profits can be used in one of the following three ways: 1) to pay dividends to the shareholders, 2) to buy back shares of stock, or 3) to reinvest the profit in the organization as retained earnings. In a nonprofit organization, the surplus can be used in only one way: It must be retained within the organization as a net asset and classified as such on the balance sheet. The surplus will be reinvested back into the organization and can *only* be used to benefit the community.

Nonprofit Paradigm

Government agencies and nonprofit organizations (NPOs) are established for the benefit of the community. Unlike for-profit counterparts, health departments and nonprofit health care organizations do not seek as the primary goal to maximize profits, but to serve the health care needs of the community in which they operate. However, nonprofit health care organizations must be run as businesses in order to ensure their long-term financial viability. It is essential for an NPO to balance its mission to serve the community against the need to operate a viable business. Both mission and viability are important for the community, and neither can receive undue emphasis at the expense of the other.

Nonprofit health care organizations are granted nonprofit status by the federal government's Internal Revenue Service (IRS) because they are organized for the benefit of the community. Typically, these entities are known as either 501C (3) or 501C (4) organizations in reference to specific sections of the IRS code. When an organization is granted nonprofit status, it enjoys four important tax benefits:

1. Exemption from taxation on income (surplus)
2. Exemption from taxation on earnings from investments
3. The ability to issue tax-free debt through government agencies
4. Qualification to receive charitable donations

In addition, at the local-community level, some nonprofit organizations are exempt from paying property taxes.

There are over 1.2 million nonprofit organizations in the United States, and only a portion of these are in the health sector. However, the health sector's nonprofit organizations create a disproportionate amount of the nonprofit activity. For example, although hospitals make up only about 1% of all tax-exempt organizations in the United States, they constitute 40% of the total revenue of nonprofit organizations (Hassan et al., 2000).

In exchange for the many benefits enjoyed by a tax-exempt organization, there are at least four important restrictions:

1. The organization must be organized for the benefit of the community.
2. There can be no inurement, which is insider gain. All employees of nonprofit organizations must not be paid excessive compensation or benefits.
3. There can be no private benefit, which means gain by someone outside the organization, such as vendors or suppliers. One way to ensure that no private benefit occurs is to require multiple bids for all services and supplies.
4. All surpluses must be invested back into the organization to help it achieve its mission. Unlike for-profit organizations, this means that there cannot be any profit distributed to owners.

Summary

In this module we examined the similarities and differences between for-profit and nonprofit organizations. Although a nonprofit must maximize profit and minimize risk in the same way that a for-profit business would, a nonprofit is bound by its tax-exempt status to reinvest any surplus (i.e., profit) back into the organization.