Profit Made, Now What?  
A Case Study

Richard R. Perry, M.A.

Abstract

A case history of how one not-for-profit mental health center used operationally-generated profit is presented. Actual and potential uses of profit, the concept of financial flexibility, the role of debt and the need for long range planning are discussed. The article concludes with a brief discussion of public relations issues faced by the profitable not-for-profit organization.

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It is easier to make a theoretical argument for the appropriateness of profit-making by a not-for-profit, charitable organization, than to develop and implement a coherent financial plan for the utilization of that profit. The ephemeral nature of profit ("where’s the cash?")

experience related to the use of profit, conflicting values regarding profit among board, staff and community, and the numerous potential uses of profit combine to make budgeting and long range planning for profit problematic for the small, growing, profitable, not-for-profit organization.

Obviously, there is no universal set of uses for profit. Every organization has its specific needs and finds itself in unique situations which guide its financial planning. There is, however, a limited number of areas that all organizations need to consider, including financial flexibility, capital improvements and major purchases, salaries and staffing, and new services. This article examines the considerations of one not-for-profit mental health center and its decision regarding the use of profit. There is nothing exemplary about this organization’s financial planning. It is, more than likely, typical of small- to medium-sized not-for-profit organizations. However, by analyzing its behavior, its experience may be instructive to others.

Background

Wheatland Professional Services (WPS) is a not-for-profit, charitable organization in north central Oklahoma. It was chartered in 1981 and has experienced steady growth with budgets increasing from $113,818 in FY/1982 to $829,430 in FY/1988. Funding is received from contracts from the Oklahoma Department of Mental Health (DMH) and other government agencies, private pay, third party payors, including Medicaid and Medicare, fees, investment interest and contributions. Most of the funding comes from the contracts with DMH, although the proportion of total funding from this source has gradually declined as new sources of

Richard R. Perry, M.A. is director of administrative services, Wheatland Professional Services, Inc., Enid, Oklahoma.
revenues have been found and state funding reduced. The proportion of funding from state contracts declined from 97% in 1981 to 77% in 1986 and to 67% in 1988.

Wheatland had shown profits before 1985 and 1986, but these were due to start-up funding by DMH and not to the operations of the center. In FY/1985, WPS reported a profit of $15,000 on total revenues of $741,568 for a profit margin of 2%. In FY/1986, however, WPS showed a profit of $61,102 on total revenues of $857,921, a profit margin of 7.12%. While a surplus of revenues over expenses, i.e., profit, had been budgeted for both years, a number of events came together in 1986 increasing profit significantly and requiring the center’s management to think in new ways about the meaning and use of profit. (Wheatland experienced a loss of $20,025 in FY/1987 due to unexpected mid-year reductions in the DMH contracts and to accounting changes required to deal with accrued vacation time. In FY/1988, Wheatland projected a profit of $22,000. Because the discussion on the use of profit began with the large surplus in FY/1986, and because the directions begun then have continued, the remainder of the discussion will focus on FY/1986.)

Where’s the Cash?

It is critical to note that WPS uses an accrual basis of accounting rather than a cash basis. Simply put, we match revenues and expenses with the period in which they were earned or incurred, not the period in which the money was received or the bills were paid. Thus, our financial statements include accounts such as depreciation, accounts receivables, prepaid expenses, accounts and notes payable, and deferred income. The purpose of these accrual-based accounting transactions is to assist the manager and the informed board member to better understand the operation and fiscal status of the organization. Another result of accrual accounting, however, is that “profit” and cash surplus are not the same. This is important because an obvious question to be put to the manager of a not-for-profit organization who is reporting a profit of over $60,000 is, “Where is the money?” Table 1 shows how the $61,102 profit for FY/1986 translated into only $12,282 in additional cash from the previous year.

This transition from profit to cash may increase the skepticism inherent in the question, “Where’s the money?” Surely profit was spent if the bank accounts record only $12,000 more than the year before. While that is not necessarily the case, the detail in Table 1 indicates that profit was used during the course of the year to purchase equipment and leasehold improvements. These improvements included the consolidation of offices and increasing square footage of our facility. Because these expenditures are considered capital acquisitions which increase the assets of an organization, they are not considered period expenses and do not enter into profit and loss calculations. Had we not made these expenditures, our profit would not have been different, but the balances in our bank accounts would have been much larger.

It is instructive to note that the decisions regarding capital expenditures were made before the profit for the year was known. The decisions were aided by profit projections and a historical review of cash balances. It is clear that decisions to use profit often precede the documentation of profit. Because they are based on the expectations of future surpluses, decisions of this significance should only be made at the highest level of the organization and with board approval.

Where else might cash suggested by a reported profit of over $60,000 be? In this case, we need to look to accounts receivable. In FY/1986, accounts receivables increased $49,418 over the year-end balance of the previous year. Our accounts receivable increased dramatically as the result of significant increases in services to Medicaid-eligible persons and a change in the Medicaid intermediary during the fourth quarter of the year which resulted in a delay in claims and payments being processed. While accounts receivables are revenues and are included in

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