Is Your Not-for-Profit Financially Fit?

By Lee Klumpp CPA, CGMA

Being financially fit and stable is critical to any business, including a not-for-profit (NFP). If a NFP has a weak financial position, it may not be able to sustain its operations. While the perception by many in today's society is that most NFPs are generally financially healthy, this is not always the case. For example, a recently published report noted that 41 percent of charities do not expect to make a profit over the next three years. An NFP's liquidity is an important story to convey to the users of its financial statements.

To determine the overall financial health of an NFP, you need to understand its financial statements. You should be able to find a copy of the NFP's financial statement that you are interested in analyzing on the NFP's website or obtain it by requesting it. Evaluating these documents will provide insight into the NFP's financial health and the basis on which management makes strategic and financial decisions. To do this evaluation effectively, you need a basic knowledge of NFP accounting methods and the ability to calculate financial ratios such as liquidity. Liquidity has also become a critical metric used by boards and stakeholders to measure the potential sustainability of an NFP.

No amount of long-term investments and capital assets will keep a nonprofit operational if its finances aren't sufficiently liquid. Having the right amount of liquid and non-liquid resources available is key for an NFP to accomplish its mission. While there is a cost associated with not having enough liquidity, there is also a forgone opportunity cost for having too much liquidity.

Liquidity Defined

Liquidity is typically defined as how much cash and/or assets (such as short-term investments) an NFP holds that can be easily converted to cash for use in the immediate or near future. An NFP is thought to be liquid if it has ready access to cash to meet its needs. An NFP may be described as liquid because it holds cash directly or because it holds other liquid assets such as money market accounts, certificates of deposits, or other short-term investments that can readily be converted to cash.

To find out whether an NFP is financially strong, calculate the total value of everything that it could use to raise cash, if necessary. This calculation includes money in the bank, accounts receivable, and inventory on hand that it can sell. If the nonprofit has investments in marketable securities, you can include these, because they are relatively easy to liquidate. Divide the total amount by the NFP's liabilities to determine what percentage of its value would be left if it had to liquidate and pay off all creditors.

How NFPs Disclose Liquidity Under New Guidance

The Financial Accounting Standards Board's Accounting Standards Update (ASU) 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*, addresses how NFPs should disclose information regarding liquidity.

Specifically, the ASU requires that an NFP disclose both quantitative and qualitative information about the liquidity of assets and near-term demands for cash as of the reporting date, including (1) the amount of financial assets at the end of the period; (2) the amount that, because of restrictions or other limitations on their use, is not available to meet cash needs in the near term; and (3) information regarding how an NFP manages its liquidity, and any other sources of cash (such as lines of credit). The FASB believes that this information will significantly improve users' ability to assess a NFP's liquidity. The ASU is effective for years beginning after Dec. 15, 2017.

Presentation of Liquidity

Qualitative Information refers to how an NFP manages its liquid resources to meet its operational cash needs within one year of the statement of financial position date. Qualitative information should be included in the footnotes and describe the availability of the NFP's financial assets. Financial assets are defined as cash, ownership interest in an entity, or a contract that allows an NFP to receive

cash or another financial instrument or to exchange financial instruments on potentially favorable terms. The availability of financial assets can be affected by:

- The nature of the asset
- External limitations on the asset that are imposed by donors, grantors, laws and contracts
- Limits on the asset that are imposed internally, for example, by governing board decisions

Quantitative Information, refers to the amount of financial assets available to meet the NFP's cash needs within one year of the statement of financial position date. Quantitative information can be included on the face of the statement of financial position or in the footnotes.

Effect on NFPs

These new disclosure requirements will provide clarity to readers of financial statements about the resources that are available to support the NFP's central and ongoing operations. The disclosures should also make it more apparent when an NFP is in a strained financial situation.

NFPs that already present their statement of financial position in a classified format that shows current and noncurrent assets and liabilities separately may discover their current presentation shows all or part of the quantitative information required by the ASU. These entities have already determined the assets expected to be realized in cash or available for use within one year of the financial statement date. However, further disaggregation of these amounts may be needed in the footnotes to fully satisfy the requirements of the ASU.

Financial Assets

NFPs will need to assess what their financial assets are and whether the current assets presented in their statement of financial position equate to the financial assets available to support general expenditures within one year from statement of financial position date.
In some instances, an NFP's current assets may be different from those available to meet cash needs for general expenditures. For example, an NFP may classify pledges to be received within one year as current in its statement of financial position, but these pledges may be restricted by donors for a specified purpose and unavailable for general expenditures — even when the cash is received.

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Common types of financial assets include:

- Cash and cash equivalents
- Short-term investments
- Receivables
- Pledges

Restrictions

Restrictions that could limit the use of assets are:

- Donor restrictions for capital expenditures or other expenses beyond the next year
- Funds designated by the board including assets for self-insurance funding, pension obligations or debt arrangements
- Assets held as collateral
- Cash balance limits resulting from contractual agreements with vendors or creditors
- Cash required to be held in separate accounts or restricted for a specific purpose
- Loan covenants

NEXT STEPS

Qualitative Disclosure

NFPs will need to develop and implement a policy to comply with qualitative information disclosure requirements for managing liquidity and liquidity risk. If an NFP doesn't currently have such a policy, the NFP should consider working with its management team and governing board to establish the policy. As with all significant organizational policies, it's a best practice to document policies in writing and review them on an ongoing basis.

Quantitative Disclosure

NFPs will want to consider creating a draft of the new quantitative disclosure. If an entity is financially strained or has limited available resources, the new quantitative disclosure requirements may result in a very small or even negative amount of financial assets available for use within a year.

This signifies a liquidity risk and may also cause management to doubt the entity's ability to continue as a going concern, per ASU 2014-15, *Presentation of Financial Statements – Going Concern* (Subtopic 205-40), which was released in August 2014. ASU 2014-15

provides guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and requires certain related footnote disclosures. This standard was effective for annual periods ending after Dec. 15, 2016.

NFPs with High Liquidity Risk

When NFPs implement the new standard, there is likely an opportunity to consider if the organization has a high liquidity risk, which means it has a minimal amount of available liquid assets or possibly a negative amount. If this is the case, management might want to consider discussing the liquidity risk with users of the financial statements — such as grantors, donors, and the bank — or obtaining a line of credit to help with operating needs if liquid resources are unavailable. The board may want to consider setting up and funding an operating reserve to improve its liquidity reserve. For more information on items to consider in setting up an operating reserve, visit the Nonprofit Operating Reserve Initiative.

Next Steps for Implementing ASU 2016-14

As NFPs prepare to implement the new requirements of ASU 2016-14, they should consider the following next steps:

- Identify financial assets and any possible limits, whether by donor restriction or board-designations, to these assets.
- Review the general ledger and financial statement report writer setup and consider whether any changes can be made to enable easier tracking of financial assets.
- Perform an analysis to determine what limits are imposed on financial assets.
- Calculate financial assets available to meet cash needs within one year.
- Consider whether a classified statement of financial position may improve your NFP's display of liquidity.

The capability of an NFP's systems to generate information to support providing these new disclosures may require re-working and re-evaluation. Additionally, NFPs may want to institute oversight related to the NFP's projected liquidity to help reduce the risk of materially misstated disclosures. The benefit of all of this is that senior management and the governing board may appreciate having readily accessible information about the NFP's resource availability to more easily determine the organization's financial fitness.

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