Are You Telling the Right Story about Your Liquidity?

What's the best way to describe your organization's liquidity?

By Lee Klumpp & Adam Cole

Liquidity is crucial for your organization. You must have the right amount of liquid and non-liquid resources available when you need them. There's a cost associated with not having enough liquidity. But there's also a foregone opportunity cost for having too much liquidity. Therefore, your liquidity is an important story to convey to those who use your financial statements.

Who are these people who're interested in knowing how liquid you are? They're your donors and other supporters of your organization as well as those who're thinking of supporting you. They're creditors, credit rating agencies, banks, and other lenders that use liquidity as a barometer of a credit-worthy organization and consider adequate liquidity a criterion for providing loans and reimbursements to you. All these groups want to know what assets you can quickly convert to cash to pay for current or future programmatic activity, debt service, and other activities.

Defining Liquidity

Liquidity is a multifaceted concept that encompasses many different meanings, so to determine how you should communicate your organization's liquidity in your financial statements, let's first consider how it is defined. Often, when users of nonprofit financial statements use the term "liquidity" they're referring to liquidity risk or financial flexibility. For the purposes of our discussion, the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) defines liquidity and the related concepts as follows:

Liquidity is defined in the ASC Master Glossary as an asset's or liability's nearness to cash. Donor-imposed restrictions may influence the liquidity or cash flow patterns of certain assets.

Financial Flexibility is defined in the ASC Master Glossary as the ability to take effective actions to alter amounts and timing of cash flows so that the organization can respond to unexpected needs and opportunities.

Liquidity Risk isn't defined in the ASC Master Glossary, but it was discussed in a recent research project by the FASB on disclosures about liquidity risk and interest rate risk. This project used the term "liquidity risk" to mean the risks and uncertainties that an organization might encounter in meeting its financial obligations.

Of course, when people talk about your liquidity, they don't have those precise definitions in mind. When they discuss how liquid your organization is, they're usually referring to how much cash (and assets, such as short-term investments, which you can easily convert to cash) that you have on hand for use in the immediate future. They consider your organization liquid if it has ready access to cash to meet its needs. They may describe your organization as liquid if it holds cash directly or holds other liquid assets such as money market accounts, certificates of deposit, or other short-term investments that can readily be converted to cash.

> "Every organization needs to have the right amount of liquid and non-liquid resources."

You might think that your organization is liquid if you have access to cash through borrowing power, lines of credit, and the like. This, however, is a faulty assumption. Access to cash through borrowing may create liquidity, but borrowing is more akin to financial flexibility and clearly isn't a liquid asset that you can communicate in the statement of financial position at the measurement date.

Accounting Requirements

The current accounting guidance for nonprofits (ASC Topic 958) requires that a nonprofit report assets and liabilities in reasonably homogeneous groups and classify them in ways that provide relevant information about their interrelationships, liquidity, and financial flexibility. You might interpret this requirement to mean that you only need to sequence your assets according to their nearness to cash and your liabilities based on the timing of their maturities. This could be correct for some small, less-complex nonprofits. However, for more complex nonprofits with endowments and sinking funds, for example, it could be misleading to classify the endowment with the nonprofit's unrestricted investments and to combine the sinking fund cash with the nonprofit's unrestricted cash and

cash equivalents. If you grouped items together solely by the nature of the asset (cash, investment, and so on) or liability, the users of your financial statements would get an unrealistic picture of your liquidity, even if you provided further details in the notes. In order for your financial-statement users to understand your liquidity, they must be able to understand the restrictions, whether donor, contractual, or legal, on your use of particular assets.

Some have argued that you can get to liquidity through analyzing a nonprofit's net assets, but net assets are solely a residual of assets less liabilities and don't convey liquidity. For net assets themselves to convey liquidity, the nonprofit would have to be able to convert the net assets to cash or use them to settle an obligation based on the definition of liquidity. Therefore, it would be difficult to communicate what net assets are available, for what purpose they can be used, and whether the net assets are with or without donor-imposed restrictions.

Nonprofits currently have flexibility under generally accepted accounting principles (GAAP) in telling their story regarding liquidity to those who read their financial statements. Here are the ways you can create a picture of your liquidity on your financial statements:

- **Sequence assets** according to their nearness of conversion to cash, and sequence liabilities according to the nearness of their maturity and resulting use of cash.
- **Classify assets and liabilities** as current and noncurrent.
- **In notes to financial statements, disclose** relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets.

Even with these options, it can still be hard to understand your organization's liquidity. Additionally, there are even difficulties in comparing liquidity within the nonprofit sector. That's because of common weaknesses in many nonprofits' financial statements, especially the following:

- **lack of information presented in the notes to the financial statements** related to the board's policy on investments, specifically around pooled investments that include both restricted and unrestricted amounts
- **lack of disclosures** about how the organization will meet its short-term liquidity needs
- **complexity of restricted contributions and designations** by the board of directors.

The FASB recently issued an exposure draft of the Proposed Accounting Standards Update (ASU), *Not-for-Profit Entities (Topic 958) and Health Care Entities (Topic 954): Presentation of Financial Statements of Not-for-Profit Entities*. This proposed ASU addresses the issue of how a nonprofit should disclose information regarding liquidity.

> "Be sure you have enough cash available for continued growth."

Specifically, the ASU proposes that a nonprofit disclose both quantitative and qualitative information about the liquidity of assets and near-term demands for cash as of the reporting date, including:

- **the amount of financial assets** at the end of the period
- **the amount that, because of restrictions** or other limitations on the assets' use, isn't available to meet cash needs in the near term
- **the amount of financial liabilities** that require cash in the near term
- **information regarding how the organization manages its liquidity,** including the time horizon it uses in the management of liquidity as well as any other sources of cash (such as lines of credit) during that time horizon.

It's believed that this information will significantly improve users' ability to assess nonprofits' liquidity risk. Stay tuned to see what the FASB board's ultimate decision is regarding the liquidity component of the ASU.

The FASB is not the only entity looking at this issue. Liquidity is also a critical metric used by boards and stakeholders to measure an organization's potential sustainability. Currently, the state of New York is working on a Medicaid transformation project that will result in enhanced reimbursements to those organizations that qualify. In order to qualify, one criterion will be that an entity has adequate liquidity.

These events highlight the need for you to be able to measure and, even more important, communicate your organization's liquidity.

What's the Best Way to Measure Your Organization's Liquidity?

Financial performance measurement is a strategy you can use to evaluate operations, programs, services, and financial stability. One of the key measurement tools is financial ratio analysis. It involves taking data from your financial statements, using it to calculate ratios appropriate for your organization, and then benchmarking those ratios against past performance, management objectives, or other organizations.

Financial ratio analysis can help you assess your overall financial condition and liquidity. It can also flag patterns that might not be conducive to your organization's success. There are three main financial ratios you can use to measure your organization's liquidity:

1. **Current ratio** equals current assets divided by current liabilities. A 2-3 ratio indicates that you have adequate liquid funds to pay your current obligations.
2. **Quick ratio** equals current assets (less any inventory amounts) divided by current liabilities. A ratio of 1-2 shows that you have adequate liquid funds to pay your current obligations without selling inventory.
3. **Organizational liquidity funds indicator** equals expendable net assets divided by average monthly total expenses. Expendable net assets are calculated as net assets less restricted endowments, fixed assets, and prepaid expenses. This indicator measures how many months you have before you will consume your liquid assets, assuming

that no additional revenue flows into your organization. The higher the ratio, the better your liquidity.

These ratios are fairly easy to calculate, and you can then benchmark your organization by comparing it to similar nonprofits. Comparing your organization's performance to benchmarks allows you to zero in on areas with the greatest potential for improvement. Using this information, you may be able to boost performance without making significant changes in your operations. Further, when comparing against similar nonprofits, you might improve performance by simply adopting best practices used by your peers. You can obtain information on other nonprofits' metrics from Web sites such as GuideStar and Charity Navigator.

Using monthly, quarterly, or even yearly financial ratio analysis can help you understand your organization's liquidity and provide you with valuable insight into your organization's financial future. You'll be able to identify the strengths and weaknesses of your organization and take appropriate actions to improve liquidity.

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> "Nonprofits have flexibility in telling their story regarding liquidity."

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