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Liquidity: Can It Be the Difference between Success and Bankruptcy for NFPs?

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Before New York's Federation Employment and Guidance Service (FEGS) filed for bankruptcy last year, nobody saw it coming. The legacy social services organization was 80 years old and had $260 million in revenues, but lurking behind those successes was a $20 million deficit. The nonprofit industry was rocked when nobody—not even the board and management—seemed to be aware of the liquidity and cash flow problems plaguing the organization.

The question everyone's been asking is "how did this happen?" Answering it requires an understanding of the complexities of nonprofit financial statements, including the importance of liquidity, performance measures and net assets, and how the tracking of financial performance differs between private for-profit firms and not-for-profits (NFPs). And from there, how and why that could soon change under guidance from the Financial Accounting Standards Board (FASB).

In practical terms, liquidity is typically understood as the amount of cash and/or assets, such as short-term investments, held by a nonprofit organization that can be easily converted to cash for use in the immediate or near future. In other words, an entity is thought to be liquid if it has ready access to cash to meet its needs. An entity may be described as liquid because it holds cash directly or because it holds other liquid assets, such as money market accounts, certificates of deposit or other short-term investments that can readily be converted to cash. Some might describe an entity as liquid if it has ready access to cash, which can include borrowing power, lines of credit, etc. It's worth noting, though, that access to cash through borrowing may create liquidity, but it is more akin to the concept of financial flexibility and is not a liquid asset that can be communicated in the statement of financial position at the measurement date.

Liquidity hasn't historically been emphasized in nonprofit financial statements other than looking at how items are sequenced on the statement of financial position (balance sheet). Nonprofit finances have been akin to a black hole when it comes to liquidity because, to date, the FASB has not required that entities measure and report on liquidity. But that could all soon change for nonprofits. As the FASB Board redeliberates on its proposed Accounting Standards Update (ASU) on presentation and disclosure for Not-for-Profit Entities, it plans on looking at ways to provide meaningful and decision-useful information related to liquidity. Comments submitted on the proposed ASU have supported improving disclosures to provide decision-useful information for assessing liquidity, as well as other indicators of financial performance. Boards, lenders, creditors and, occasionally, big donors tend to be the biggest users of nonprofit financial statements. While mission and overhead typically face a great deal of scrutiny from all of these stakeholders, in our examination of failing nonprofit organizations, critical financial information around liquidity is opaque—or worse, not present at all.

In its redeliberations on the proposed ASU, the board discussed providing qualitative and quantitative information useful for assessing liquidity and potential alternatives and directed the staff to explore an alternative approach that would:

- require qualitative information about how the NFP manages its liquidity and liquidity risks, and
- allow for alternative ways of presenting quantitative information that would emphasize information about assets that are liquid and available at the balance sheet date.

Currently, one of the biggest problems for readers of nonprofit financial statements is that nonprofit financial statements do not read like for-profit financial statements, which emphasize financial performance and return on investment for stockholders. Nonprofits, which have no stockholders, are prohibited by the FASB's Accounting Standards Codification from using phrases like "net income" or "operating income," so their statements don't provide much information on financial performance. This can have serious implications for stakeholders, internal and external, who are trying to glean information about the overall health and sustainability of the nonprofit organization. Additionally, nonprofits currently do not have standards or a framework to measure and report on key performance indicators (KPI) about financial performance. As part of its redeliberations, the board plans to look at how NFPs use operating measures and see if there is a way to improve disclosures for those NFPs that choose to present such a measure.

In 1989, FASB decided that it preferred the direct method to calculate cash flow, but still allowed nonprofits to use the indirect method, which is simpler to provide but gives little information about where cash comes from and where it goes. So far in its deliberations, the FASB has decided to allow nonprofits to use the direct method of measuring cash flow without having to present the reconciliation of change in net assets to cash provided or used in operating activities, which had previously been required if the NFP used the indirect method of cash flows.

Another recent redeliberation decision that FASB made is to require nonprofits to present better disclosures related to net assets with and without restrictions, in order to provide more meaningful information and a better understanding of the resources available to the organization versus resources that are set aside to meet a donor's intent. Without that distinction, most of an organization's net assets may be locked up in various ways-such as endowments, property and plant, or other restrictions or designations—which may lead stakeholders to falsely believe the funds are available for use when they are not.

While there are advantages to reporting on liquidity, there are also concerns nonprofits must address while FASB continues to fine-tune its requirements, including the effect this new information on cash flow could have on donors. An organization with faltering liquidity may either face skepticism from major donors or, conversely, it could see an influx of donations from supporters who see a dire need for resources. Moreover, a group flush with cash might have more trouble raising funds if donors start to direct donations toward organizations they perceive have a greater need. In any case, before any changes to financial reports become mandatory, nonprofit leaders should become keenly aware of their liquidity and cash flow situation and prepare to address their stakeholders accordingly.

Anytime there's a transition, organizations will face some costs associated with transitioning. Organizations would need to get up to speed with the new reporting requirements, which might involve an investment in new systems and/or training. Fortunately for organizations, the changes FASB is considering will not add any expense over the longer term once these initial costs even out. Rather, they are simple measures intended to encourage better measurement and communication of liquidity on the part of nonprofit organizations. And most importantly, they are designed to help the users and readers of statements better understand the financial results, which is something that should ultimately benefit the financial health of nonprofits.