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The Key to Long Term Financial Health: Liquid Unrestricted Net Assets (LUNA)

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Everyone knows that these have been difficult times for nonprofits. Our own research at Fiscal Management Associates (FMA) and countless other surveys by intermediaries and industry associations find that nonprofits have been struggling with cutbacks in government funding, reduced corporate and foundation grantmaking, and weakened individual giving.

These fiscal pressures have led, in many cases, to annual operating deficits and emergency use of endowment funds or other financial reserves – if nonprofits had any to begin with. While there is widespread agreement about the general problem, many individual nonprofits still need strategies and solutions for conducting a realistic assessment of their own financial situations and to implement budgetary and financial management strategies appropriate for the still very perilous times ahead.

The Starting Point: LUNA

Most nonprofit CEOs and Boards of Directors focus their financial attention on development and monitoring of their agency's annual budget. If the budget is balanced – with projected expenditures matching anticipated revenues – then everyone is usually happy.

However, there is another area of focus that can provide the best guide to an organization's underlying financial condition – the Balance Sheet. It offers a snapshot of a nonprofit's fiscal health at a specific moment in time, including the liquidity of its net worth. The balance sheet reveals in detail key aspects of an agency's current financial strengths and weaknesses, i.e. accrued assets and liabilities, and gives an indication of how a nonprofit might withstand possible fiscal stress in the future.

By comparing its current balance sheet with those at prior points of time – last month, last quarter, last year, and prior years -- you can see how your agency's fiscal health has fared over time. Have net assets or cash on hand been dropping as you dipped into reserves to cover operating costs? Do increasing Accounts Receivable raise questions about the collectability of Medicaid billings? Are growing Accounts Payable an indication that you are delaying your own payments to vendors as a way of dealing with a structural deficit?

One critical balance sheet "vital sign" is "Liquid Unrestricted Net Assets" – otherwise referred to at FMA as LUNA. These are the amounts of cash, receivables, and liquid investments that an agency has on hand that are not designated for specific purposes by the terms of government contracts, foundation grants or individual donor intent. Adequate levels of liquid unrestricted net assets allow the leaders of nonprofit organizations to manage routine cash flow, support future programming or new opportunities, invest in and maintain facilities and other capital assets, and weather economic downturns or (financially) unsuccessful ventures. Organizations with a negative or only narrowly positive LUNA balance have very little financial "cushion" to pursue opportunities or mitigate risks. An awareness of LUNA is therefore critical for organizations as they pursue their missions. Both parts of this definition – "Liquid" and "Unrestricted" -- are important. While it is fine to have substantial assets in the form of land, buildings, and capital equipment, an organization cannot use these resources to make payroll or cover day-to-day expenses. It is essential to know how much of your agency's assets are readily available in the event that government reimbursements begin to lag or an entire grant or contract is cancelled.

It is also important to focus on "unrestricted" funds. In reality, many nonprofits deposit monies from a variety of funding sources into a single bank account, so just looking at how much cash is in the bank can mask the fact that some of an organization's money may be for restricted purposes. It is important to track your unrestricted reserves to ensure that you always know how much of your cash balance is truly available at your organization's discretion.

How much Liquid Unrestricted Net Assets should your agency have? That depends! This is a question to be answered by each individual organization and depends on upcoming cash needs, predictability of revenues, seasonality, flexibility to adjust operations, and access to other resources. In general, banking organizations recommend a LUNA equal to three months of operating expenses – a goal that many organizations see as extremely difficult to achieve, particularly those that are funded by government. Whatever your LUNA goal, the important part is to have the goal and develop strategies to maintain it.

Building financial reserves is the key step to a healthy LUNA

Unfortunately, too many nonprofits have never taken steps to build up their agency's financial reserves in the first place. They have fallen prey to the generally accepted view that nonprofits should never make a "profit" on the services they provide. Without a surplus--some excess in revenue above your actual cost of providing services--there is no way to generate reserves that can carry you over rough patches in funding or help launch new and vital programmatic initiatives.

The "balanced budget" for which so many nonprofits strive can in fact be part of the problem. For organizations that do not have a reserve, balancing revenue and expenses to zero will ensure they never will; for those fortunate enough to have one, merely balanced budgets threaten the reserves you do have, given the uncertainty on expected revenues. The first step towards building a financial reserve is to create an organizational culture that accepts and strives to generate operating surpluses. It requires buy-in from the Board of Directors and acknowledgement from line staff. Nonprofits can be transparent in their plans to establish reserves by developing a long-term plan that outlines financial goals and clear policies regarding how reserves will be used to strengthen the agency and better achieve its mission. The board can determine how much of its unrestricted net assets to make available for management to use as needed ("Operating Reserve"), how much to set aside for a rainy day ("Board Designated") and how much to earmark for a specific strategic goal ("Special Purpose"). While an organization can certainly plan to maintain reserves in all three categories, it should see these funds as distinct, or else it may find the same pot of money is stretched too thin.

One critical "special purpose" reserve category is the establishment of capital replacement funds. Budgets should cover the estimated depreciation on buildings and equipment. This simply ensures that you will have funds available when it is time to replace these essential capital assets. Surprisingly, since depreciation is not a cash expense, some nonprofits do not even consider budget shortfalls less than the amount of depreciation to be real deficits. That is a serious mistake.

Reserves can be created in one of two ways: via a board resolution that requires any anticipated surplus for the year to be automatically transferred to a "reserve" account, or alternatively, by adding a "Current Year Contribution to Reserves" line item into your budget. This option indicates that the contribution is an expected activity for the year, and one to be "raised" with the same priority as the costs of staff, facilities and supplies.

Will a healthy LUNA hurt an organization's fundraising efforts?

While in the past some philanthropic entities may have been concerned about an organization accumulating excess assets, for many foundations the perspective has changed. Funders today usually want to support sustainable organizations who can withstand the challenges of an economic downturn, or an unexpected drop in revenues.

What is the first step?

Begin each planning process with a long term perspective beyond the current year – realizing that each year of operations needs to be evaluated from its impact to the long term health of the organization. Will this year's results strengthen your LUNA?

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