

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

By Hilda Polanco

Friday, May 25, 2012

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?

Hilda H. Polanco is Founder and Managing Director of Fiscal Management Associates LLC, which provides fiscal management, accounting, organizational and technology consulting services for nonprofit organizations.

Nonprofit Financial Health Analysis: SAMPLE

Organization Name: Example Nonprofit, Inc.



End of Current Fiscal Year: 12/31/2016

		1. Three Years Ago	2. Two Years Ago	3. Last Year (Actuals)	4. Current Year (Budget)
Fiscal Year Ending:		12/31/2013	12/31/2014	12/31/2015	12/31/2016
Statement of Activities	Did your organization have an operating surplus or deficit?				
	Unrestricted Revenue & Support	\$1,211,710	\$1,219,603	\$1,252,965	\$1,300,500
	<i>Less:</i>				
	Total Expenses	\$1,428,868	\$1,372,447	\$1,189,573	\$1,200,750
	Change in Unrestricted Net Assets or "Operating Surplus or (Deficit)"	(\$217,158)	(\$152,844)	\$63,392	\$99,750
Statement of Activities	What was the mix of unrestricted revenue? (use only unrestricted in calculations)				
	Individual Contributions Revenue	\$100,500	\$98,759	\$85,469	\$91,000
	Individual Contributions Revenue % $\left(\frac{\text{Individual Contributions Revenue}}{\text{Total Revenue}} \right)$	8%	8%	7%	7%
	Foundation/Corporate Revenue	\$326,982	\$323,930	\$362,647	\$375,500
	<i>Plus:</i>				
	Satisfaction of Restrictions	\$120,000	\$110,000	\$98,000	\$135,000
	Foundation/Corporate Revenue % $\left(\frac{\text{Foundation/Corporate Revenue}}{\text{Total Revenue}} \right)$	37%	36%	37%	39%
	Government Funding	\$559,700	\$592,450	\$592,390	\$600,000
	Government Funding % $\left(\frac{\text{Government Funding}}{\text{Total Revenue}} \right)$	46%	49%	47%	46%
	Earned Income	\$88,578	\$79,529	\$90,895	\$82,908
	Earned Income % $\left(\frac{\text{Earned Income}}{\text{Total Revenue}} \right)$	7%	7%	7%	6%
	Other Income (<i>self calculating</i>)	\$15,950	\$14,935	\$23,564	\$16,092
Other Income % $\left(\frac{\text{Other Income}}{\text{Total Revenue}} \right)$	1%	1%	2%	1%	
Statement of Functional Expenses	How are resources allocated across programs and supporting services?				
	Total Program Expense	\$1,129,323	\$1,087,430	\$985,614	\$950,650
	Program Expense % $\left(\frac{\text{Program Expenses}}{\text{Total Expenses}} \right)$	79%	79%	83%	79%
	Total Management & General Expense	\$128,765	\$118,058	\$115,894	\$115,850
	Management & General Expense % $\left(\frac{\text{Management & General Expenses}}{\text{Total Expenses}} \right)$	9%	9%	10%	10%
	Total Fundraising Expense	\$170,780	\$166,959	\$88,065	\$134,250
Fundraising Expense % $\left(\frac{\text{Fundraising Expenses}}{\text{Total Expenses}} \right)$	12%	12%	7%	11%	
Balance Sheet	How liquid are the organization's reserves?				
	Unrestricted Net Assets (A)	\$114,417	\$30,000	\$24,965	
	Board Designated Net Assets (B)	\$0	\$0	\$0	
	Fixed Assets, net of depreciation	\$64,393	\$39,393	\$14,393	
	<i>Less:</i>				
	Mortgages or other debt associated with fixed assets	\$0	\$0	\$0	
	Fixed Assets, net of related debt (C)	\$64,393	\$39,393	\$14,393	
LUNA: Liquid Unrestricted Net Assets (A-B-C)	\$50,024	(\$9,393)	\$10,572		

Nonprofit Financial Health Analysis: SAMPLE

Organization Name: Example Nonprofit, Inc.



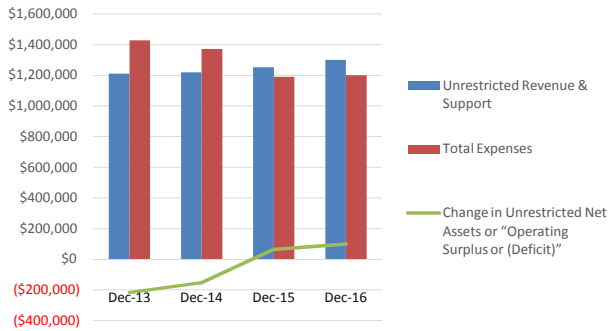
End of Current Fiscal Year: 12/31/2016

		1. Three Years Ago	2. Two Years Ago	3. Last Year (Actuals)	4. Current Year (Budget)
Fiscal Year Ending:		12/31/2013	12/31/2014	12/31/2015	12/31/2016
Income Statement & Balance Sheet	How many months of operations can be covered with liquid operating reserves?				
	Available LUNA from above calculation	\$50,024	(\$9,393)	\$10,572	
	<i>Divided by Average Monthly Expenses:</i>				
	Total Annual Expenses ÷ 12	\$119,072	\$114,371	\$99,131	
	Months Covered by Liquid Reserves	0.4	(0.1)	0.1	
	How many months of operations can be covered with the available cash?				
	Cash & Cash Equivalents	\$297,389	\$274,139	\$256,781	
	<i>Divided by Average Monthly Expenses:</i>				
	Total Annual Expenses ÷ 12	\$119,072	\$114,371	\$99,131	
	Months of Cash on Hand	2.5	2.4	2.6	

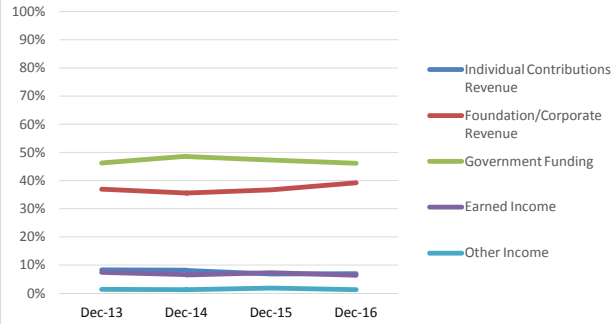
Balance Sheet	Additional Resources				
	Board Designated Net Assets (aka Board Designated Reserves)	\$235,843	\$578,346	\$456,246	
	Temporarily Restricted Net Assets	\$210,000	\$190,763	\$165,900	
	Permanently Restricted Net Assets	\$100,000	\$100,000	\$100,000	

Operating Results

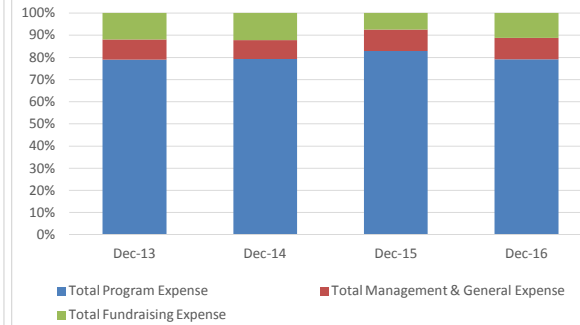
Operating Surplus (Deficit)



Operating Revenue Mix

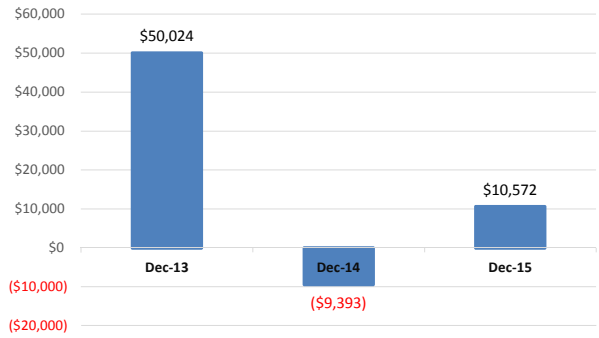


Functional Expense Mix

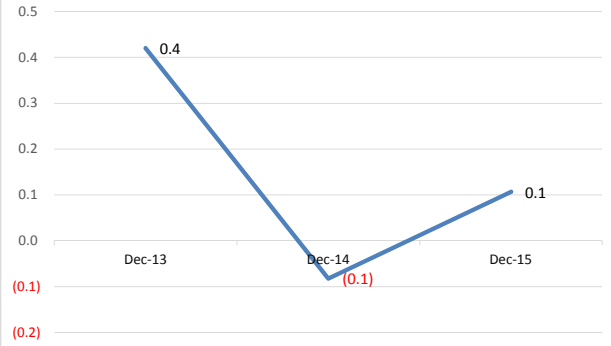


Net Assets

LUNA Balance

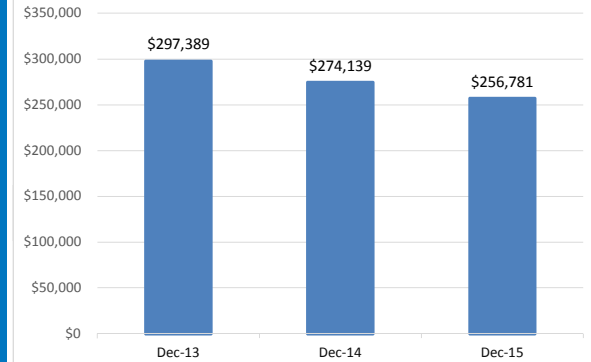


Months of LUNA

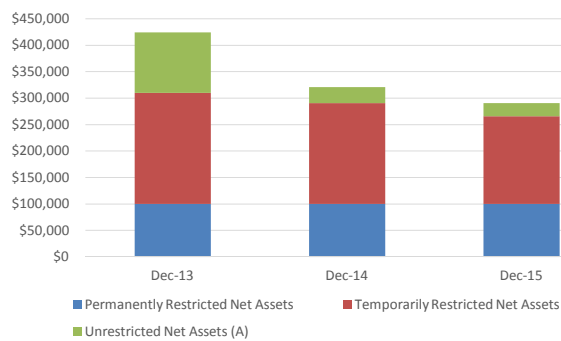


Cash on Hand

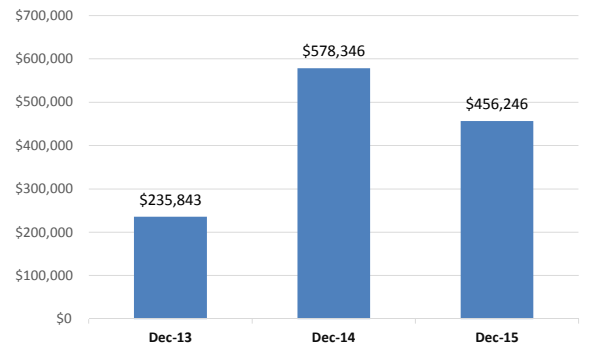
Cash Balance



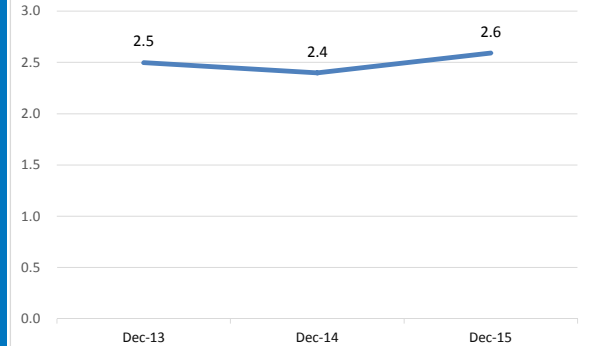
Net Assets, Including Temp. & Perm. Restricted



Board Designated Net Assets



Months of Cash on Hand





It's Up to Nonprofits and State and Local Governments to Turn the Promise of the OMB Uniform Guidance into Reality for Individuals, Communities Served, and Taxpayers

For Immediate Release
December 19, 2014

Contact: Rick Cohen, Director of Communications and Operations
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 Email: rcohen@councilofnonprofits.org

Tim Delaney, President and CEO of the National Council of Nonprofits, issues the following comments in response to the federal government publishing the [interim final regulations on the Office of Management and Budget \(OMB\) Uniform Guidance](#).

"The interim final rules published today implementing the [OMB Uniform Guidance](#) represent the federal government's official recognition that all governments entering into written agreements with nonprofits to deliver services to the public have an affirmative duty to pay their fair share of the costs that those nonprofits incur. The changes promised by the new rules are a major victory for people who depend on nonprofits every day.

"If properly implemented, the new rules will finally end the harmful practice of governments, including those at the state and local levels, imposing artificially low limits on the reimbursement of indirect costs that nonprofits must incur when delivering services on behalf of governments. Those arbitrary caps have essentially forced charitable nonprofits to subsidize government. This updating of antiquated policies reflects the reality that, for the federal government to successfully deliver its programs through contracts and grants, its nonprofit partners – just like for-profit contractors and governments themselves – must pay for the internal controls and organizational infrastructure required to efficiently and effectively deliver those services.

"To **our partners in government**, the National Council of Nonprofits pledges to work collaboratively to promote consistent interpretations and application of the Uniform Guidance and ensure full and fair implementation of the cost principles and other federal grants reform. As processes are adjusted to implement these new rules, it is the best opportunity for governments and nonprofits, working together, to reduce the costly burdens and streamline the entire contacting and grants process, from application to final reporting, and save countless hours and taxpayer dollars.

"To **nonprofit leaders**, we stress that the Uniform Guidance provides only the promise of improved treatment, and that it is incumbent upon each organization to (1) take action to own its own costs, (2) learn its rights under the new rules, and (3) protect those rights through advocacy, both on its own behalf with each grant and contract, as well as by engaging in efforts with the broader nonprofit community.

"To **foundation leaders and program officers**, we ask for your help in alerting your nonprofit grantees to the promise of the Uniform Guidance and of their need to utilize and protect their rights. If funding is needed to establish stronger cost allocation systems in individual grantees, to provide professional development for grantees and/or the sector in your region, and to help the sector to engage in broader advocacy efforts so state and local governments fully comply, we hope you will see these as mission-based investments that will strengthen the organizations you support and a welcome step toward reducing the need for your foundation to constantly fill gaps in government funding.

"The National Council of Nonprofits and its nationwide network of state associations of nonprofits will be actively monitoring implementation of the Uniform Guidance, equipping nonprofits with the tools they need to properly allocate and manage their costs and stand up for their rights to be reimbursed, and collaborating with government officials to fix broken systems to increase efficiency and save taxpayer dollars. At the end of the day, this is a win-win-win for nonprofits, governments, and most importantly, people in communities across America. Let's get to work, together."

Background

The process for establishing the Uniform Guidance (sometimes misidentified as a "Super Circular") was undertaken

by the Office of Management and Budget (OMB) to ease administrative burdens, increase efficiency and effectiveness of federal awards, and strengthen the oversight of federal funds to reduce the risks of waste, fraud, and abuse. The OMB Uniform Guidance merges eight separate, yet overlapping, OMB circulars. It presents a comprehensive overhaul of the federal grantmaking process that should lead to consistency across governments and the entities with which they contract to provide services.

To charitable nonprofits providing services in communities on behalf of governments, the Uniform Guidance incorporates significant reforms, including the following three. First, the Uniform Guidance explicitly requires pass-through entities (typically states and local governments receiving federal funding) and all federal agencies to reimburse a nonprofit's indirect costs by applying the nonprofit's federally negotiated indirect cost rate, if one already exists. If a negotiated rate does not yet exist, then nonprofits are empowered either to negotiate a rate based on federal guidelines, or to elect the default rate of 10 percent of their modified total direct costs (MTDC). Second, the Uniform Guidance specifies more costs that are directly reimbursable, and clarifies numerous definitions and cost allocation rules. Third, it raises the threshold for single audits to \$750,000, reducing the administrative costs for approximately 5,000 nonprofits, as well as governments, while also focusing efforts to reduce risk of waste, fraud, and abuse.

For more information, see our [webpage on the OMB Uniform Guidance](#).

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The National Council of Nonprofits is a trusted resource and advocate for America's charitable nonprofits. Through our powerful network of State Associations and 25,000-plus members – the nation's largest network of nonprofits – we serve as a central coordinator and mobilizer to help nonprofits achieve greater collective impact in local communities across the country. We identify emerging trends, share proven practices, and promote solutions that benefit charitable nonprofits and the communities they serve. Learn more at www.councilofnonprofits.org.

COMMUNITY ARTS ORGANIZATION, INC.
STATEMENTS OF FINANCIAL POSITION
AS OF JUNE 30, 2015 AND 2014

	2015	2014
ASSETS		
<u>Current Assets</u>		
Cash	\$ 257,590	\$ 286,052
Accounts Receivable	82,482	67,697
Prepaid Expenses	21,200	17,259
Total Current Assets	361,272	371,008
<u>Non-Current Assets</u>		
Property and Equipment, Net	1,506,326	1,545,689
TOTAL ASSETS	\$ 1,867,598	\$ 1,916,697
 LIABILITIES AND NET ASSETS		
LIABILITIES		
<u>Current Liabilities</u>		
Accounts Payable	\$ 104,434	\$ 101,369
Current Portion of Mortgage Payable	36,442	31,573
Deferred Revenue	917	1,084
Total Current Liabilities	141,793	134,026
<u>Non-Current Liabilities</u>		
Long-Term Mortgage Payable	1,028,713	1,065,155
TOTAL LIABILITIES	\$ 1,170,506	\$ 1,199,181
 NET ASSETS		
Unrestricted Net Assets	492,947	576,734
Temporarily Restricted Net Assets	204,145	140,782
TOTAL NET ASSETS	\$ 697,092	\$ 717,516
TOTAL LIABILITIES AND NET ASSETS	\$ 1,867,598	\$ 1,916,697

COMMUNITY ARTS ORGANIZATION, INC.
STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2015
With Comparative Totals for the Year Ended June 30, 2014

	2015			2014
	Unrestricted	Temporarily Restricted	Total	Total
REVENUES				
Government Grants & Contracts	\$ 978,042	\$ 77,162	\$ 1,055,204	\$ 1,108,731
Foundations and Corporations	389,319	272,500	661,819	569,379
Individuals	98,389	2,048	100,437	43,885
Fundraising Events (Net of Expenses)	80,978	3,868	84,846	100,061
Interest	220	-	220	34
Miscellaneous Earned Revenue	32,473	-	32,473	10,100
In-Kind	21,785	-	21,785	37,366
Net Assets Released from Restrictions	292,215	(292,215)	-	-
TOTAL REVENUES AND PUBLIC SUPPORT	\$ 1,893,421	\$ 63,363	\$ 1,956,784	\$ 1,869,556
EXPENSES				
Program Services	\$ 1,419,559	\$ -	\$ 1,419,559	\$ 1,396,897
Management & General	339,190	-	339,190	221,264
Development	218,459	-	218,459	162,946
TOTAL EXPENSES	\$ 1,977,208	\$ -	\$ 1,977,208	\$ 1,781,107
CHANGE IN NET ASSETS	\$ (83,787)	\$ 63,363	\$ (20,424)	\$ 88,449
NET ASSETS AT BEGINNING OF YEAR	576,734	140,782	717,516	629,067
NET ASSETS AT END OF YEAR	\$ 492,947	\$ 204,145	\$ 697,092	\$ 717,516

COMMUNITY ARTS ORGANIZATION, INC.
STATEMENT OF FUNCTIONAL EXPENSES
FOR THE YEAR ENDED JUNE 30, 2015
With Comparative Totals for the Year Ended June 30, 2014

	2015			2014	
	<u>Program Services</u>	<u>Management & General</u>	<u>Fundraising</u>	<u>Grand Total</u>	<u>Total</u>
Salaries	\$ 876,792	\$ 209,501	\$ 134,931	\$ 1,221,225	\$ 1,100,103
Employee Benefits	85,174	20,351	13,108	118,632	106,866
Payroll Taxes	59,621	14,246	9,175	83,043	74,806
Professional Fees	111,229	26,577	17,117	154,923	139,558
Occupancy	39,395	9,413	6,063	54,870	49,428
Equipment Lease and Maintenance	6,282	1,501	967	8,750	7,882
Equipment Purchase	7,588	1,813	1,168	10,569	9,521
Supplies	72,440	17,309	11,148	100,897	90,890
Telephone	23,243	5,554	3,577	32,374	29,163
Advertising / Marketing	4,040	965	622	5,627	5,069
Printing and Publications	9,799	2,341	1,508	13,649	12,295
Postage and Shipping	1,901	454	293	2,648	2,385
Travel	22,705	5,425	3,494	31,624	28,488
Professional Development	5,278	1,261	812	7,351	6,622
Conferences and Meetings	7,456	1,782	1,147	10,385	9,355
Dues and Subscriptions	3,721	889	573	5,183	4,669
Insurance	18,974	4,534	2,920	26,428	23,807
Interest	17,189	4,107	2,645	23,942	21,567
Depreciation	42,548	10,166	6,548	59,262	53,384
Bad Debt Expense	2,793	667	430	3,890	3,504
Miscellaneous	1,390	332	214	1,936	1,744
TOTAL EXPENSE	<u>\$ 1,419,559</u>	<u>\$ 339,190</u>	<u>\$ 218,459</u>	<u>\$ 1,977,208</u>	<u>\$ 1,781,107</u>

www.StrongNonprofits.org

Resources for Nonprofit Financial Management

Sections and Selected Resources

Planning

Strengthening the budget development process

- [A Five-Step Guide to Budget Development](#) *
 - Webinar recording (28 minutes)
 - PowerPoint presentation

Projecting cash flow

- [Cash Flow Projection Template for Nonprofit Financial Mangers](#) (Excel) *

Calculating the true cost of programs

- [Program-Based Budget Builder](#) (Excel) *

Planning for and addressing financial uncertainty

- [Revenue Analysis Worksheet](#) (Excel) *

Planning for growth

- [How Nonprofits Get Really Big](#) (article)

Connecting organizational goals with financial realities

- [Funding Opportunity Assessment Tool](#) (online interactive) *

Monitoring

Maximizing financial reports

- [Nonprofit Unified Chart of Accounts](#) (Excel)

Understanding and interpreting financial information

- [How to Talk About Finances So Non-Financial Folks Will Listen](#) (article)

Managing government contracts

- [Contract Wizardry: Conjuring Impact from Government Contracts](#) (article)

Managing restricted funds

- [Temporarily restricted net assets \(TRNA\) schedule](#) (Excel) *

Operations

Understanding nonprofit accounting

- [Nonprofit Accounting Basics: Accounting 101](#) (tutorial)

Strengthening internal controls

- [Nonprofit Policies and Procedures Handbook](#) (template)

Maximizing accounting software

- [Financial Management Software Systems for Nonprofit Organizations](#) (comparison matrix) *

Developing cost allocations

- [Program-Based Budget Template](#) (Excel) *

Enhancing efficiencies, communication and workflow

- [Checklist for Monthly Closing Process](#) (Excel) *

Governance

Understanding the board's fiduciary responsibilities

- [The Board's Financial Leadership](#) *
 - Webinar recording (25 minutes)
 - PowerPoint presentation

Enhancing the board's knowledge of nonprofit financial management

- [A Nonprofit Dashboard and Signal Light for Boards](#) (article)

Defining roles and responsibilities of finance and audit committees

- [Nonprofit Auditor Selection Guide](#) (handbook) *

Planning for financial sustainability

- [Operating Reserve Policy Toolkit for Nonprofit Organizations](#) (handbook)

Managing risk

- [Downloadable Nonprofit Policy Samplers](#) (template)

General

- [An Executive Director's Guide to Financial Leadership](#) (article)
- [The Nonprofit Starvation Cycle](#) (article)

* represents a new resource developed specifically for the StrongNonprofits.org web site