OPTIONS FOR MEASURING UNIVERSITY FINANCIAL STRENGTH

ABOR and the university finance staffs have researched and considered several options for measuring the financial strength of our universities for use in the context of our Annual Financial Ratio Analysis and the System Strategic Plan. Those options are:

1. IPEDS benchmark data for select financial variables.


3. AGB’s Delta Project on Postsecondary Education Costs, Productivity and Accountability.

1. **IPEDS data.**

The Integrated Postsecondary Education Data System (IPEDS) is the core postsecondary education data collection program for the National Center for Education Statistics (NCES) in the Institute of Education Sciences in the U.S. Department of Education. Data is collected from all primary providers of postsecondary education in the country in areas including enrollments, program completions, graduation rates, faculty, staff, finances, institutional prices, and student financial aid.

IPEDS data tools enable the user to create comparison groups against which to compare each of our universities, providing up to the 5 most recent years’ data. The user then selects those variables upon which to report comparison data. IPEDS can compare our university to the median of its comparison group and can also provide the variable data for each comparison institution. In addition, IPEDS prepares graphs of each variable, comparing our university to the comparison group median. The challenge will be to select those variables that are the best indicators of financial strength.

ABOR and university staff also reviewed a data base compiled by John Minter Associates. The source of the data is IPEDS. This data base provides trends in 99 ratios and financial data bases for 3 fiscal years. The Minter ratios do not include component unit data, thus prohibiting measurement of the financial strength of the total institution. This is not a user-friendly software and it is questionable if it is of much benefit beyond what ABOR and university staff can develop using IPEDS.


*Strategic Financial Analysis for Higher Education, 6th Edition,* is a continuation of work begun in the 1970’s by Peat, Marwick, Mitchell & Co. and continued by its successor firm, KPMG LLP. The 3rd and 4th editions, in 1995 and 1999, respectively, were viewed by many leaders in higher education “as milestone publications in finance for private
institutions.” It was these editions that the U.S. Department of Education (DOE) used as the basis for measuring the financial health of colleges and universities receiving Title IV (financial aid) funds. In turn, the Higher Learning Commission of the North Central Association of Colleges and Schools (NCA-HLC) used the work of the DOE and the methodology in those earlier editions to evaluate the financial health of the private institutions to which they award accreditation.

In May 2007 the NCA-HLC began collecting from public institutions the same financial data as they had already been collecting from private institutions. Using the 6th edition methodology, the NCA-HLC collected 4 years of financial data and calculated 4 core ratios and a Composite Financial Index (CFI) (see ratio definitions and CFI scale in Appendix A). The NCA-HLC requests this data from all public universities under their purview—not just those institutions up for initial accreditation or reaffirmation of their accreditation. HLC plans to build to a 10-year history for each institution.

This methodology relies on the following 4 core ratios and a summary index:

1. **Primary Reserve Ratio:** Are resources sufficient and flexible enough to support the mission? (Note: CU = Component Units)

   \[
   \frac{\text{Expendable Net Assets} + \text{CU Expendable Net Assets}}{\text{Total Expenses} + \text{CU Total Expenses}}
   \]

   This ratio is our current Ratio 7 in our Annual Financial Ratio Analysis with the exception that the above formula includes component unit data.

2. **Viability Ratio:** Are resources, including debt, managed strategically to advance the mission?

   \[
   \frac{\text{Expendable Net Assets} + \text{CU Expendable Net Assets}}{\text{Long-Term Debt (Total Project-Related Debt)} + \text{CU Long-Term Debt}}
   \]

   This ratio is similar to, but not identical, to Ratio 10 in our current Annual Financial Ratio Analysis.

3. **Return on Net Assets Ratio:** Does asset performance and management support the strategic direction?

   \[
   \frac{\text{Change in Net Assets} + \text{CU Change in Net Assets}}{\text{Total Net Assets} + \text{CU Total Net Assets}}
   \]

   Our current Annual Financial Ratio Analysis does not have a comparable ratio.

4. **Net Operating Revenues Ratio:** Do operating results indicate the institution is living within available resources?
Operating Income (Loss) + Net Nonoperating Revenues (Expenses) + CU
Change in Unrestricted Net Assets
Operating Revenues + Nonoperating Revenues + CU Total Unrestricted
Revenue

This ratio is similar to Ratio 6 in our current Annual Financial Ratio Analysis.

The 4 core ratios can be converted to a common scale, given a strength factor, and then benchmarked to median ratios for our peer institutions.

**Composite Financial Index (CFI)**

The above 4 core ratios provide information on the overall financial health of the institution. KPMG, and the NCA-HLC, who has adopted this methodology, uses these 4 ratios to create one overall financial measurement of the public institution’s health. The KPMG 6th edition explains this overall measurement—the Composite Financial Index—as follows:

“The Composite Financial Index (CFI) is useful in helping governing boards and senior management understand the financial position that the institution enjoys in the marketplace. Moreover, this measurement will also prove valuable in assessing future prospects of the institution, functioning as an ‘affordability index’ of a strategic plan.

Since we introduced the concept and methodology of the CFI in the 4th edition in 1999, it has been adopted by many leading institutions and found great acceptance by senior management and governing boards. We are convinced that the CFI is a very valuable tool for senior managers and boards of trustees to help understand not only the state of an institution’s financial situation at a point in time but also serve as a valuable tool, unavailable from other sources, that can provide insight into the trends of an institution’s key financial indicators.

We believe this for several reasons. First, by blending the four key measures of financial health into a single number, a more balanced view of the state of the institution’s finances is possible because a weakness in one measure may be offset by the strength of another measure. Second, by using the same criteria to determine the CFI over a period of time, the board and management are given the opportunity to measure the overall financial progress that it is making. Lastly, the measure is easily understood and remembered, so it can become part of institutional communications on where the institution is as well as how far the institution has come.

We have also found, however, that applying the CFI as a peer group measure has some limitations. This is different from the comparison of an
individual ratio, where senior managers of an institution believe they have the capability to understand the action to take if an individual ratio is different from another institution. This relates to the fact that there are a limited number of most likely reasons for movement in a selected ratio. However, when the ratios are combined, the underlying reasons for change may be indiscernible because of the number of possible variations.

The CFI only measures the financial component of an institution’s well-being. It must be analyzed in context with other associated activities and plans to achieve an assessment of the overall health, not just financial health, of the institution. As an example, if two institutions have identical CFI scores but one requires substantial investments to meet its mission-critical issues and the other has already made those investments, the first institution is less healthy than the second. In fact, an institution’s CFI can become too high as well as too low. When put in the context of achievement of mission, a very high CFI with little achievement of mission may indicate a failing institution.”

The Ohio Board of Regents, as the result of one of its community colleges becoming financially insolvent, adopted a ratio analysis methodology to increase financial accountability over its 14 universities, 15 community colleges, and 8 technical colleges. Using ratios developed in an earlier edition of Strategic Financial Analysis for Higher Education, Regents staff calculates 3 ratios for each institution: (1) Viability Ratio, (2) Primary Reserve Ratio, and (3) Net Income Ratio. These calculated ratios are assigned a score and weighted, resulting in a composite score. While not as comprehensive as the methodology in the 6th edition, the Ohio work tells us that other governing boards are looking for ways to monitor the financial health of their institutions and are implementing some version of the KPMG methodology.

If the KPMG 6th edition methodology is used for our purposes, ABOR and university finance staffs would work to collect financial data from our peer institutions to benchmark norms and/or targets.

3. The Delta Project on Postsecondary Education Costs, Productivity and Accountability.

Mindful of intensifying demands for greater campus efficiencies in this era of accountability, the Association of Governing Boards of Universities and Colleges (AGB) launched The Delta Project on Postsecondary Education Costs, Productivity and Accountability in 2006, with a grant from the Robert W. Woodruff Foundation. The project, under the leadership of Dr. Jane Wellman, Executive Director, is a nationwide research effort and dialogue on ways higher education leaders can control costs and boost productivity while improving institutional quality.
This multiyear effort, scheduled to finish its work in 2008, hopes to identify effective cost-saving measures being taken by public and private institutions and to stimulate a national dialogue on costs—on campus and throughout higher education. The project has published a series of white papers for boards, policymakers, and administrators; will offer guidance for on-campus discussions of cost containment; and has made and will make presentations at AGB meetings. The deliverables from this project may be useful in refining the key performance indicators in our System Strategic Plan.

**NEXT STEPS**

- Continue discussions with university Chief Financial Officers and Controllers on options to refine recommendations.

- Bring recommendations to the Strategic Planning, Budget and Finance Committee in early Fall 2008.

April 16, 2008
APPENDIX A: RATIO DEFINITIONS

- **Overall Financial Health**
  - Primary Reserve Ratio
  - Viability Ratio
  - Return on Net Assets Ratio
  - Net Operating Revenues Ratio

- **Secondary Reserve Ratio**
  - Debt Burden Ratio
  - Net Financial Assets Ratio
  - Net Tuition Dependency Ratio

- **Capitalization Ratio**
  - Capitalization Ratio
  - Debt Coverage Ratio
  - Debt Coverage Ratio
  - Net Physical Assets Ratio
  - Net Tuition Dependency Ratio

- **Leverage Ratio**
  - Leverage Ratio
  - Physical Asset Reinvestment Ratio
  - Age of Facilities Ratio
  - Net Tuition Dependency per FTE Ratio

- **Short-term Leverage Ratio**
  - Short-term Leverage Ratio
  - Age of Facilities Ratio
  - Net Tuition Dependency per FTE Ratio

- **Net Physical Assets Ratio**
  - Short-term Leverage Ratio
  - Age of Facilities Ratio
  - Net Tuition Dependency per FTE Ratio

- **Physical Asset Reinvestment Ratio**
  - Short-term Leverage Ratio
  - Age of Facilities Ratio
  - Net Tuition Dependency per FTE Ratio

- **Facilities Maintenance Ratio**
  - Age of Facilities Ratio
  - Net Tuition Dependency per FTE Ratio

- **Deferred Maintenance Ratio**
  - Age of Facilities Ratio
  - Net Tuition Dependency per FTE Ratio

**Questioning on Ratios:**
- Are resources sufficient and flexible enough to support the mission?
- Are resources, including debt, managed strategically to advance the mission?
- Does asset performance and management support the strategic direction?
- Do operating results indicate the institution is living with available resources?