System Wide Services

Core Financial Ratios and Composite Financial Index
FY06 to FY09
The financial health of System Wide Services (SWS) can be evaluated through the use of industry benchmarks and ratios. The following ratios and related benchmarks are derived from Strategic Financial Analysis for Higher Education, Sixth Edition published by KPMG; Prager, Sealy & Co., LLC; and Bearing Point. This book is widely used in the higher education industry and the most recent edition includes guidance specifically for public institutions of higher education. Ratios presented for the University of Maine System (UMS) were obtained from the January 5, 2010 Ratio Analysis report prepared by KPMG.

Within the reporting entity known as SWS there are two cost pools (benefits and risk management) operated for the benefit of the entire UMS. SWS management does not consider the net assets associated with these cost pools to be readily available to fund SWS operations. Therefore, in this report we have presented each of the ratios at two levels:

- SWS - All activities of, and net assets held by, the System Office including the cost pools; and
- SWS-Op – SWS activities and net assets excluding the cost pools.

The Primary Reserve Ratio provides a snapshot of financial strength and flexibility by indicating how long the institution could function using its expendable reserves (both unrestricted and restricted, excluding net assets restricted for capital investments) without relying on additional net assets generated by operations. This ratio is calculated as follows:

\[
\text{Primary Reserve Ratio} = \frac{\text{Expendable Net Assets}}{\text{Total Expenses}}
\]

<table>
<thead>
<tr>
<th>Year</th>
<th>Benchmark</th>
<th>SWS-Op Actual</th>
<th>SWS Actual</th>
<th>UMS Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY06</td>
<td>0.400</td>
<td>0.520</td>
<td>0.870</td>
<td>0.240</td>
</tr>
<tr>
<td>FY07</td>
<td>0.400</td>
<td>0.680</td>
<td>1.080</td>
<td>0.276</td>
</tr>
<tr>
<td>FY08</td>
<td>0.400</td>
<td>0.630</td>
<td>0.930</td>
<td>0.257</td>
</tr>
<tr>
<td>FY09</td>
<td>0.400</td>
<td>0.510</td>
<td>1.240</td>
<td>0.232</td>
</tr>
</tbody>
</table>

(0.100)
The benchmark ratio of .40 provides about 5 months (40% of 12 months) of expenses. Key items that can impact the primary reserve ratio include principal payments on debt, use of unrestricted net assets to fund capital construction projects, operating results (revenues – operating expenses + net nonoperating revenues + depreciation), endowment returns, and total operating expenses.

Over the past four years, SWS-Op’s reserve levels have been sufficient to provide about 6 to 8 months of expenses. It is, however, important to note that SWS-Op’s reserves cover not only its expenses, but also serve as emergency funds for campuses with accumulated deficits that do not have adequate reserves. As noted above, the ratio for the UMS indicates coverage of less than 3 months which means that some of the UMS campuses have very low ratios.

Several factors have impacted SWS-Op’s primary reserve ratio over the past four years:

- High investment returns that surpassed budgeted amounts helped build expendable net assets in FY06 and FY07. Market returns dropped off significantly during FY08 and during FY09 expendable net assets had to be used to help offset the impact of heavy investment losses.
- Repayment of internal construction loans at the end of FY09 by the University of Maine and the University of Southern Maine helped to offset the impact of negative results from operations. Repayment of such loans improves the primary reserve ratio because it reclassifies SWS’ net assets from “invested in capital assets” to “unrestricted net assets”.

The primary reserve ratios for SWS are significantly higher than SWS-Op due to the net assets associated with the cost pools, primarily the benefit pool. For the benefit pool, a benefit rate is assessed to the campuses based on projected costs for a given year and the actual benefit costs are accumulated in the pool. Due to volatility in benefit costs, the rate assessed to the campuses may be too high or too low compared to actual experience. The resulting over or under recovery impacts SWS’ ratio.

Benefit Pool experience over the past four years is as follows:

- In FY06, SWS retroactively applied a lower benefit rate; thereby, reducing the cost of benefits it had already assessed the campuses for FY06. Once the benefit pool numbers were finalized for the year, SWS also transferred $1 million to the campuses.
- In FY07, SWS transferred $3.2 million of the over recovery to the campuses and transferred the remaining $2.5 million to a benefit pool reserve to offset future costs.
- In FY08, SWS absorbed a cost under recovery by transferring $.9 million from the benefit pool reserve.
- In FY09, SWS transferred the $4.6 million cost over recovery to the benefit pool reserve in anticipation of a large increase in FY10 post employment health costs, which helped minimize the increase in the FY10 benefit rate.
The **Net Operating Revenues Ratio** is a measure of operating results and answers the question, “Do operating results indicate that the University is living within available resources?” Operating results either increase or decrease net assets and, thereby, impact the other three core ratios: Primary Reserve, Return on Net Assets, and Viability. This ratio is calculated as follows:

\[
\text{Operating Income (Loss) plus Net Non-Operating Revenues} \\
\text{Operating Revenues plus Non-Operating Revenues}
\]

<table>
<thead>
<tr>
<th></th>
<th>FY06</th>
<th>FY07</th>
<th>FY08</th>
<th>FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Low Benchmark</strong></td>
<td>2.00%</td>
<td>2.00%</td>
<td>2.00%</td>
<td>2.00%</td>
</tr>
<tr>
<td><strong>High Benchmark</strong></td>
<td>4.00%</td>
<td>4.00%</td>
<td>4.00%</td>
<td>4.00%</td>
</tr>
<tr>
<td><strong>SWS-Op Actual</strong></td>
<td>-3.70%</td>
<td>4.80%</td>
<td>-11.00%</td>
<td>-64.90%</td>
</tr>
<tr>
<td><strong>SWS Actual</strong></td>
<td>15.30%</td>
<td>15.00%</td>
<td>-12.10%</td>
<td>-31.00%</td>
</tr>
<tr>
<td><strong>UMS Actual</strong></td>
<td>1.40%</td>
<td>2.60%</td>
<td>0.40%</td>
<td>1.60%</td>
</tr>
</tbody>
</table>
A target of at least 2% to 4% is a goal over an extended time period, although fluctuations from year to year are likely. A key consideration for institutions establishing a benchmark for this ratio would be the anticipated growth in total expenses.

In FY06, SWS’ ratio is higher than that for SWS-Op because of the $4.6 million noncapital transfer to establish the benefit pool reserve. This transfer is reported as part of SWS-Op’s net nonoperating revenues. For SWS as a whole this transfer has no impact.

The high ratio in FY07 for both SWS and SWS-Op is attributable to investment market returns that surpassed budgeted amounts. In FY08, the benefit pool experienced an under recovery of costs and investment returns also dropped significantly, resulting in negative ratios for both SWS and SWS-Op. In FY09, investment losses drove SWS-Op’s ratio significantly lower; while an over recovery in the benefit pool tempered the ratio drop for SWS as a whole.

<<Continued on page 5>>
The **Return on Net Assets Ratio** measures asset performance and management. It determines whether an institution is financially better off than in the previous year by measuring total economic return. It is based on the level and change in total net assets. This ratio is calculated as follows:

\[
\text{Return on Net Assets Ratio} = \frac{\text{Change in Net Assets}}{\text{Total Beginning of the Year Net Assets}}
\]

The nominal rate of return is adjusted for inflation (Higher Education Price Index) to arrive at the real rate. Items that may impact this ratio include those that impact the net operating revenues ratio, along with endowment returns, capital appropriations, capital gifts and grants, capital transfers, and endowment gifts.

SWS-Op’s real rate of return on net assets has gone from a high of 7.6% in FY07 to a low of -28.1% in FY09. The primary reasons for this drop are declining market returns on both operating and endowment investments and a drop in State of Maine capital appropriation dollars over the past two years. Other
factors contributing to the FY09 decline are the transfer of University College net assets to the University of Maine at Augusta on July 1, 2008 and capital transfers to the University of Maine at Fort Kent and the University of Maine at Machias as match money on State of Maine capital appropriation dollars.

In FY06, SWS’ ratio is higher than that for SWS-Op because of the same $4.6 million noncapital transfer that impacted the net operating revenues ratio. SWS’ rates of return were significantly higher than those for SWS-Op in FY07 and FY09 due to cost over recoveries in the benefit pool.

The **Viability Ratio** measures SWS’ expendable resources that are available to cover debt obligations (e.g., capital leases, notes payable, and bonds payable). This ratio is calculated as follows:

\[
\text{Expendable Net Assets}^* - \text{Long-Term Debt}
\]

* Excluding net assets restricted for capital investments

A ratio of 1.00 or greater indicates that there are sufficient resources to satisfy debt obligations. Like the primary reserve ratio, the viability ratio is impacted by such items as principal payments on debt, use of unrestricted net assets to fund capital construction projects, operating results (operating revenues – operating expenses + net nonoperating revenues + depreciation) and endowment returns. Issuance of new debt would also impact the ratio.
SWS-Op has outstanding debt for two system-wide projects: the 1998 digital library project and the PeopleSoft implementation project. SWS-Op has sufficient resources to satisfy its debt obligations. As noted in the discussion of the primary reserve ratio, reserves related to the benefit pool and the risk management pool cause SWS’ ratios to be higher than those of SWS-Op.

The **Composite Financial Index (CFI)** creates one overall financial measurement of the institution’s health based on the four core ratios: primary reserve ratio, net operating revenues ratio, return on net assets ratio, and viability ratio. The CFI is calculated by:

- Determining the value of each ratio;
- Converting the value of each ratio to strength factors along a common scale;
- Strength factors are then multiplied by specific weighting factors; and
- The resulting four numbers are totaled to reach the single CFI score.

These scores do not have absolute precision. They are indicators of ranges of financial health that can be indicators of overall institutional well-being, when combined with nonfinancial indicators. This would be consistent with the fact that there are a large number of variables that can impact an institution and influence the results of these ratios. However, the ranges do have enough precision to be indicators of the institutional financial health, and the CFI as well as its trend line, over a period of time, can be the single most important measure of the financial health for the institution.
A score of 1.0 indicates very little financial health; 3, the low benchmark, represents a relatively stronger financial position; and 10, the top range of the scale. In comparing the above scores for SWS and SWS-Op, we see the impact of the benefit pool and the risk management pool on the financial health of SWS. This chart also demonstrates SWS-Op’s dependency on investment income returns; as the markets fell significantly in FY09, so did SWS-Op’s CFI score.

Each ratio’s strength factor and the total CFI score can be evaluated on the following parameters (based on a floating scale):

<table>
<thead>
<tr>
<th>Score</th>
<th>Performance Indication</th>
</tr>
</thead>
<tbody>
<tr>
<td>-1 to 1</td>
<td>Assess institutional viability to survive</td>
</tr>
<tr>
<td>0 to 3</td>
<td>Re-engineer the institution</td>
</tr>
<tr>
<td>2 to 5</td>
<td>Direct institutional resources to allow transformation</td>
</tr>
<tr>
<td>4 to 7</td>
<td>Focus resources to compete in future state</td>
</tr>
<tr>
<td>6 to 9</td>
<td>Allow experimentation with new initiatives</td>
</tr>
<tr>
<td>8 to 10</td>
<td>Deploy resources to achieve a robust mission</td>
</tr>
</tbody>
</table>

The strength factors for the four core ratios can be mapped on a diamond to show a Graphic Financial Profile of SWS’ financial health compared to the industry benchmarks. The charts on the following pages graphically display how each of the core ratios relates to one another as part of the CFI. Two institutions could have the same CFI score, yet have very different looking charts depending on the individual ratio results.

The center point of the graphic financial profile is zero. Any value that actually falls below zero defaults to the center of the graph. The maximum value in the graph is 10; thus, any actual values greater than 10 are not plotted beyond the outer diamond. The smaller, heavily lined diamond represents the low industry benchmark of 3. The institution’s ratio values are plotted and shaded to show how the institution’s health compares with the low and high benchmarks. Unless there is an unusual circumstance, an institution would want the plotting of its ratios to at least shade the entire smaller diamond.

As shown in the following charts, the shape of SWS-Op’s and SWS’ financial health in FY07 thru FY09 was similar; however, the CFI scores were significantly different. In FY06, the shapes were very different as SWS-Op had a strength factor of zero for the net operating revenues ratio, largely due to a noncapital transfer out of SWS-Op’s net assets to establish the benefit pool reserve.
System Wide Services
Core Financial Ratios and Composite Financial Index
FY06 to FY09

Graphic Financial Profile - FY06
SWS - Op
CFI Score of 2.2

Graphic Financial Profile - FY07
SWS - Op
CFI Score of 4.8

Graphic Financial Profile - FY08
SWS - Op
CFI Score of .7

Graphic Financial Profile - FY09
SWS - Op
CFI Score of -9.7
System Wide Services
Core Financial Ratios and Composite Financial Index
FY06 to FY09

Graphic Financial Profile - FY06
SWS
CFI Score of 6.0

- Primary Reserve Ratio
- Net Operating Revenues Ratio
- Return on Net Assets Ratio
- Viability Ratio

Actual □ Low Benchmark - 3

Graphic Financial Profile - FY07
SWS
CFI Score of 7.2

- Primary Reserve Ratio
- Net Operating Revenues Ratio
- Return on Net Assets Ratio
- Viability Ratio

Actual □ Low Benchmark - 3

Graphic Financial Profile - FY08
SWS
CFI Score of 2.0

- Primary Reserve Ratio
- Net Operating Revenues Ratio
- Return on Net Assets Ratio
- Viability Ratio

Actual □ Low Benchmark - 3

Graphic Financial Profile - FY09
SWS
CFI Score of -1.0

- Primary Reserve Ratio
- Net Operating Revenues Ratio
- Return on Net Assets Ratio
- Viability Ratio

Actual □ Low Benchmark - 3