System Wide Services

Core Financial Ratios and Composite Financial Index

FY06 to FY10
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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, Seventh Edition published by KPMG; Prager, Sealy & Co., LLC; and ATTAIN. This book is widely used in the higher education industry and includes guidance for both private and public institutions. Ratios presented for the University of Maine System (UMS) were obtained from the separately prepared “Core Financial Ratios and Composite Financial Index” report prepared for the UMS.

According to the above publication, there are four fundamental financial questions that need to be addressed. Analysis of four core ratios can help us answer these questions.

- Are resources sufficient and flexible enough to support the mission? - **Primary Reserve Ratio**
- Do operating results indicate the institution is living within available resources? - **Net Operating Revenues Ratio**
- Does asset performance and management support the strategic direction? - **Return on Net Assets**
- Are financial resources, including debt, managed strategically to advance the mission? - **Viability Ratio**

When combined, these four ratios deliver a single measure of SWS’ overall financial health, hereafter referred to as the **Composite Financial Index**.

The reporting entity known as SWS encompasses the following cost and revenue pools operated for the benefit of the entire University of Maine System (UMS):

- Benefit cost pool
- Risk management cost pool
- Investment income pool (FY10+)

SWS management does not consider the net assets associated with the above operations to be readily available to fund SWS operations. Therefore, in this report we have presented each of the ratios at two levels:

- SWS-Op – SWS activities and net assets excluding the above noted cost and revenue pools and
- SWS - All activities of, and net assets held by, SWS including the above noted cost and revenue pools.

Prior to FY10, the investment income pool was included as part of SWS-Op as the System Office was dependent on this revenue stream to balance its budget. Beginning in FY10, the System Office reduced its reliance on investment income and committed to placing the earnings
above budget in a ‘budget stabilization’ reserve to benefit all campuses in the event of a State appropriation curtailment or other economic crisis.

Data previously presented by SWS-Op and SWS for FY06 through FY09 has been updated in this report to reflect the following changes made in the Seventh Edition of Strategic Financial Analysis for Higher Education:

- The lowest possible value for each strength factor used in calculating the Composite Financial Index (see page 13) is now -4 rather than the previous low of 0. The highest possible value remains at 10 and the low benchmark remains at 3.

- The scale for scoring the Composite Financial Index (see page 14) has been updated to reflect the new range of -4 to 10 rather than the previous range of -1 to 10.
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:

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

- A ratio of .40 (provides about 5 months) or better is advisable to give institutions the flexibility to manage the enterprise.

- 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 (operating revenues – operating expenses + net nonoperating revenues + depreciation), endowment returns, and total operating expenses.
Components – SWS-Op:

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<th>FY07</th>
<th>FY08</th>
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<tbody>
<tr>
<td>Expendable net assets</td>
<td>$14,849</td>
<td>$19,843</td>
<td>$17,166</td>
<td>$13,336</td>
<td>$16,887</td>
</tr>
<tr>
<td>Expenses</td>
<td>$28,526</td>
<td>$29,357</td>
<td>$27,088</td>
<td>$26,275</td>
<td>$20,907</td>
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Components - SWS:

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<tr>
<th></th>
<th>FY06</th>
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</thead>
<tbody>
<tr>
<td>Expendable net assets</td>
<td>$20,159</td>
<td>$28,313</td>
<td>$25,385</td>
<td>$26,434</td>
<td>$40,346</td>
</tr>
<tr>
<td>Expenses</td>
<td>$23,294</td>
<td>$26,197</td>
<td>$27,338</td>
<td>$21,342</td>
<td>$15,963</td>
</tr>
</tbody>
</table>

Over the past five years, SWS-Op’s reserve levels have been sufficient to provide about 6 to 10 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 that do not have adequate reserves. As noted above, the ratio for the UMS is significantly less at less than 3 months of coverage.

Several factors have impacted both SWS-Op’s and SWS’ primary reserve ratio over the past five 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”.

- FY09 expenses included a $4.3 million one-time transfer of University College’s net assets to the University of Maine at Augusta effective July 1, 2008.

- In FY10, investment income revenues and related expenses and the new budget stabilization reserve were removed from the definition of ‘SWS-Op’ as the System Office reduced its reliance on investment income to balance its budget.
The primary reserve ratios for SWS are significantly higher than SWS-Op due to the net assets associated with the cost and revenue pools, primarily the benefit pool and the investment income pool (FY10). 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 higher or lower than actual experience. The resulting over or under recovery impacts SWS’ ratio. Benefit Pool experience over the past five 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.

- In FY10, SWS transferred the $5 million cost over recovery to the benefit pool reserve to help build the reserve to a level recommended by the UMS’ actuary. The cost over recovery was primarily attributable to actual post retirement costs being less than budgeted costs due to efforts made by the Retiree Health Plan Task Force (RHPTF) III to reduce post retirement health costs.
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:

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

The authors of *Strategic Financial Analysis for Higher Education*, note the following:

> The primary reason institutions need to generate some level of surplus over long periods of time is because operations are one of the sources of liquidity and resources for reinvestment in institutional initiatives. Conversely, generating a known deficit in the short term may well be the best strategic decision a board makes, if it is an affordable investment in its future and the deficit will clearly be eliminated through specific actions.

Components – SWS-Op:

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<th></th>
<th>FY06</th>
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</thead>
<tbody>
<tr>
<td>Operating income (loss) plus net non-operating revenues</td>
<td>($1,025)</td>
<td>$1,472</td>
<td>($2,694)</td>
<td>($10,338)</td>
<td>$2,506</td>
</tr>
<tr>
<td>Operating revenues plus non-operating revenues</td>
<td>$27,501</td>
<td>$30,828</td>
<td>$24,394</td>
<td>$15,937</td>
<td>$23,413</td>
</tr>
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Components - SWS:

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<thead>
<tr>
<th></th>
<th>FY06</th>
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<th>FY09</th>
<th>FY10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating income (loss) plus net non-operating revenues</td>
<td>$4,207</td>
<td>$4,632</td>
<td>($2,944)</td>
<td>($5,053)</td>
<td>$13,399</td>
</tr>
<tr>
<td>Operating revenues plus non-operating revenues</td>
<td>$27,501</td>
<td>$30,828</td>
<td>$24,394</td>
<td>$16,289</td>
<td>$29,362</td>
</tr>
</tbody>
</table>

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.
In FY10, investment income was $12.1 million higher than in FY09; thus, accounting for the jump in SWS’ ratio.

The jump in SWS-Op’s ratio from FY09 to FY10 was attributable to the exclusion of investment income activity from the definition of SWS-Op’s operations. In FY09, an investment loss had been included in SWS-Op’s ratio calculations.

Also impacting both SWS-Op’s and SWS’ FY10 ratio was the recognition of $1.6 million of grant revenue from the final close out of two fixed price contracts with the State of Maine.
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. An improving trend in this ratio indicates that the institution is increasing its net assets and is likely to be able to set aside financial resources to strengthen its future financial flexibility. This ratio is calculated as follows:

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

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<tr>
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<tbody>
<tr>
<td><strong>Benchmark</strong></td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
</tr>
<tr>
<td><strong>SWS-Op nominal rate</strong></td>
<td>4.56%</td>
<td>10.45%</td>
<td>-5.08%</td>
<td>-25.78%</td>
<td>4.92%</td>
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<tr>
<td><strong>SWS-Op Real Rate</strong></td>
<td>-0.54%</td>
<td>7.65%</td>
<td>-10.08%</td>
<td>-28.08%</td>
<td>4.02%</td>
</tr>
<tr>
<td><strong>SWS Real Rate</strong></td>
<td>9.66%</td>
<td>12.08%</td>
<td>-9.81%</td>
<td>-17.20%</td>
<td>21.77%</td>
</tr>
<tr>
<td><strong>UMS Real Rate</strong></td>
<td>1.01%</td>
<td>4.56%</td>
<td>-3.51%</td>
<td>-0.70%</td>
<td>7.65%</td>
</tr>
</tbody>
</table>
The nominal rate of return on net assets is the actual return calculated/unadjusted for inflation or other factors. The real rate of return adjusts the nominal rate for the effects of inflation using the Higher Education Price Index.

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.

Components – SWS-Op:

<table>
<thead>
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<tbody>
<tr>
<td>FY06</td>
<td>FY07</td>
</tr>
<tr>
<td>Change in total net assets</td>
<td>$2,332</td>
</tr>
<tr>
<td>Total net assets (beginning of year)</td>
<td>$51,173</td>
</tr>
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Components - SWS:

<table>
<thead>
<tr>
<th></th>
<th>$ in thousands</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY06</td>
<td>FY07</td>
</tr>
<tr>
<td>Change in total net assets</td>
<td>$7,564</td>
</tr>
<tr>
<td>Total net assets (beginning of year)</td>
<td>$51,252</td>
</tr>
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</table>

Several factors have impacted both SWS-Op’s and SWS’ return on net assets ratio over the past five years:

- The drop in return from FY07 to FY09 is primarily due to declining market returns on both operating and endowment investments and a drop in State of Maine capital appropriation dollars.

- 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 FY10, positive market returns for both operating and endowment investments contributed to the increase in SWS’ ratio. Endowment returns also impacted SWS-Op’s ratio. As previously mentioned in this report, operating investment income was excluded from SWS-Op’s activities in FY10.

- 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.

• SWS’ rate of return was significantly higher than SWS-Op again in FY10 due to a cost over recovery in the benefit pool and removal of the investment income pool from SWS-Op’s operations.
The **Viability Ratio** measures expendable resources that are available to cover debt obligations (e.g., capital leases, notes payable, and bonds payable) and generally is regarded as governing an institution’s ability to assume new debt. This ratio is calculated as follows:

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

* Excluding net assets restricted for capital investments

- A ratio of 1.00 or greater indicates sufficient resources to satisfy debt obligations.
- The authors of *Strategic Financial Analysis for Higher Education*, note the following:
  
  There is no absolute threshold that will indicate whether the institution is no longer financially viable. However, the Viability Ratio, along with the Primary Reserve Ratio discussed earlier, can help define an institution’s “margin for error”. As the Viability Ratio's value falls below 1:1, an institution’s ability to respond . . . , to adverse conditions from internal resources diminishes, as does its ability to attract capital from external sources and its flexibility to fund new objectives.

- 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

<table>
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<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>1.25</td>
<td>1.09</td>
<td>1.48</td>
<td>0.73</td>
</tr>
<tr>
<td>FY07</td>
<td>1.25</td>
<td>1.53</td>
<td>2.18</td>
<td>0.75</td>
</tr>
<tr>
<td>FY08</td>
<td>1.25</td>
<td>1.41</td>
<td>2.09</td>
<td>0.77</td>
</tr>
<tr>
<td>FY09</td>
<td>1.25</td>
<td>1.01</td>
<td>1.99</td>
<td>0.72</td>
</tr>
<tr>
<td>FY10</td>
<td>1.25</td>
<td>1.39</td>
<td>3.32</td>
<td>0.99</td>
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revenues + depreciation) and endowment returns. Issuance of new debt would also impact the ratio.

- Components – SWS-Op:

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<tr>
<td>Long-term debt</td>
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<td>$12,983</td>
<td>$12,149</td>
<td>$13,262</td>
<td>$12,155</td>
</tr>
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</table>

Components - SWS:

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<td>$40,346</td>
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<td>$12,983</td>
<td>$12,149</td>
<td>$13,262</td>
<td>$12,155</td>
</tr>
</tbody>
</table>

- 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, the risk management pool, and the budget stabilization fund 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. By blending these 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.

Because 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 of the institution. A high CFI is not necessarily indicative of a successful institution, although a low CFI generally is indicative of additional challenges. When considered in the context of achievement of mission, a very high CFI with little achievement of mission may indicate a failing institution.

The CFI is calculated by:

1. Determining the value of each ratio;
2. Converting the value of each ratio to strength factors along a common scale;
3. Multiplying the strength factors by specific weighting factors; and
4. Totaling the resulting four numbers 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

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</thead>
<tbody>
<tr>
<td><strong>Low Benchmark</strong></td>
<td>3.0</td>
<td>3.0</td>
<td>3.0</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td><strong>High Benchmark</strong></td>
<td>10.0</td>
<td>10.0</td>
<td>10.0</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td><strong>SWS-Op Actual</strong></td>
<td>2.3</td>
<td>4.8</td>
<td>1.9</td>
<td>1.0</td>
<td>4.8</td>
</tr>
<tr>
<td><strong>SWS Actual</strong></td>
<td>6.0</td>
<td>7.2</td>
<td>3.3</td>
<td>3.7</td>
<td>9.1</td>
</tr>
<tr>
<td><strong>UMS Actual</strong></td>
<td>2.0</td>
<td>2.5</td>
<td>1.5</td>
<td>1.6</td>
<td>3.3</td>
</tr>
</tbody>
</table>
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.

- SWS-Op and SWS scores reported for FY08 and FY09 are higher than the scores reported last year due. They have been restated to address the change in the scoring scale previously mentioned on page 2 of this report.

- In comparing the above scores for SWS and SWS-Op, we see the impact of the benefit, risk management, and investment income (FY10) pools on the financial health of SWS. This chart also demonstrates SWS-Op’s prior dependency on investment income returns; as the markets fell significantly in FY09, so did SWS-Op’s CFI score.

Performance of the CFI score can be evaluated on a scale of -4 to 10 as shown on the following page.
The overlapping arrows represent the ranges of measurement that an institution may find useful in assessing itself.

We have overlaid the scoring scale with the FY10 CFI scores for the UMS, SWS-Op, and SWS.
To improve on the significantly lower score for the UMS, SWS resources are being invested in projects to aid the campuses in making a transformation while at the same time ensuring that resources are available to address the following:

- An unfunded actuarial accrued liability of $144.9 million as of the last actuarial calculation date (7/1/09). In accordance with generally accepted accounting principles, this liability is not recorded in the UMS' financial statements; thus, it is not included in the calculation of the ratios included in this report.

- The UMS' workers compensation plan and health insurance plan are both self-insured. Consequently, the UMS needs to ensure that it has reasonable reserves available to address a catastrophic event. Management has been working with its actuaries in defining a reasonable level of reserves.

- Maintaining reserves and ratios sufficient to satisfy bond rating agencies and maintain or improve the UMS' current ratings. Currently, the UMS has $198 million in outstanding bonds. Of this amount, $30 million is in the form of a balloon payment that will need to be refinanced before March 1, 2012.
The strength factors that were used in calculating the CFI can be mapped on a diamond to show the shape of an institution’s financial health compared to the industry benchmarks. This Graphic Financial Profile can assist management in determining whether a weakness in one ratio is offset by strength in another ratio.

Illustrated below are two examples of a Graphic Financial Profile (GFP): one based on strength factors valued at the low industry benchmark of 3 and one with strength factors valued above and below the benchmark:

- The center point of the graphic financial profiles is -4 as illustrated in the Seventh Edition of Strategic Financial Analysis for Higher Education. An actual value that falls below -4, defaults to a value of -4 and is plotted at the center of the graph.

- The maximum value in the graph is 10; thus, an actual value greater than 10 is not plotted beyond the outer diamond.

- The smaller, heavily lined diamond represents the low industry benchmark of 3.

- The actual values of the institution’s ratio strength factors are plotted and shaded to show how the institution’s health compares with the low (3) and high (10) benchmarks.
The following graphs contain SWS-Op’s and SWS’ Graphic Financial Profiles for FY06 thru FY10. In FY06, the shapes were very different as SWS-Op had a strength factor of -4 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.
The shape of SWS-Op's and SWS' financial health in FY07 thru FY09 was similar; however, the CFI scores were significantly different.

**Graphic Financial Profile - FY07**
**SWS - Op.**
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of 4.8

**Graphic Financial Profile - FY07**
**SWS**
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of 7.2
Graphic Financial Profile - FY08
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of 1.9

Actual ◼ Low Benchmark: 3 ◼ High Benchmark: 10

Graphic Financial Profile - FY08
SWS
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of 3.3

Actual ◼ Low Benchmark: 3 ◼ High Benchmark: 10
Financial health in FY09 is represented by a thin line up the center of the chart as the two strength factors for returns were at the bottom end (-4) of the chart.

**Graphic Financial Profile - FY09**

**SWS - Op.**

Strength Factors Plotted on a Scale of -4 to 10

CFI Score of 1.0

- Primary Reserve Ratio: 3.83
- Net Operating Revenues Ratio: 2.42
- Return on Net Assets Ratio: -4.00
- Viability Ratio: -4.00

**Graphic Financial Profile - FY09**

**SWS**

Strength Factors Plotted on a Scale of -4 to 10

CFI Score of 3.7

- Primary Reserve Ratio: 9.32
- Net Operating Revenues Ratio: 4.77
- Return on Net Assets Ratio: -4.00
- Viability Ratio: -4.00
The shape of SWS-Op’s and SWS’ financial health differed in FY10 as SWS’ health was driven by the return of positive investment income which drove two of SWS’ strength factors to the top end of the scale.

**Graphic Financial Profile - FY10**

**SWS - Op.**
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of 4.8

- Primary Reserve Ratio: 6.09
- Net Operating Revenues Ratio: 10.00
- Viability Ratio: 3.33
- Return on Net Assets Ratio: -2.46

**Graphic Financial Profile - FY10**

**SWS**
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of 9.1

- Primary Reserve Ratio: 9.40
- Net Operating Revenues Ratio: 10.00
- Viability Ratio: 7.96
- Return on Net Assets Ratio: 10.00

Actual
Low Benchmark: 3
High Benchmark: 10