University of Southern Maine

Core Financial Ratios and Composite Financial Index

FY06 to FY13
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**Change in Terminology from Prior Reports**

In FY13, the University of Maine System adopted Governmental Accounting Standards Board Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. Pursuant to the provisions of Statement No. 63, all University of Maine System campuses including the University of Southern Maine updated their financial statements to reflect the residual measure in the statement of net position as net position, rather than net assets. For consistency with the financial statements, we have updated this ratio report to reference net position rather than net assets. This change in terminology has no impact on the calculation of each core ratio or the core financial index.

**Overview**

The financial health of the University of Southern Maine (USM) 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 Position*
- **Are financial resources, including debt, managed strategically to advance the mission?** - *Viability Ratio*

When combined, these four ratios deliver a single measure of USM’s overall financial health, hereafter referred to as the **Composite Financial Index**.
The **Primary Reserve Ratio** provides a snapshot of financial strength and flexibility by indicating how long the institution could function using its expendable net position (both unrestricted and restricted, excluding net position restricted for capital investments) without relying on additional net position generated by operations. This ratio is calculated as follows:

\[
\text{Expendable Net Position*} \div \text{Total Expenses}
\]

* Excluding net position restricted for capital investments

Key items that can impact the primary reserve ratio include principal payments on debt, use of unrestricted net position to fund capital construction projects, operating results (operating revenues – operating expenses + nonoperating revenues – nonoperating expenses + depreciation), endowment returns, and total operating expenses.

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

At the lowest point (FY08) in the last eight years, USM’s expendable net position covered one week of expenses. At the highest point (FY13), expendable net position covered two months of expenses which is less than half of the industry benchmark of five months.

The increase in USM’s primary ratio over the past five years is a reflection of management’s focus on increasing unrestricted expendable net position in order to increase the financial health and flexibility of the University.
<table>
<thead>
<tr>
<th>Ratio Components</th>
<th>FY06</th>
<th>FY07</th>
<th>FY08</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
<th>FY13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrestricted Expendable Net Position</td>
<td>$ (269)</td>
<td>$ (5,033)</td>
<td>$ (5,281)</td>
<td>$ (2,239)</td>
<td>$ 8,697</td>
<td>$ 16,943</td>
<td>$ 18,202</td>
<td>$ 18,266</td>
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<tr>
<td>Restricted Expendable Net Position</td>
<td>$ 14,372</td>
<td>$ 17,039</td>
<td>$ 8,525</td>
<td>$ 12,710</td>
<td>$ 13,319</td>
<td>$ 14,724</td>
<td>$ 14,108</td>
<td>$ 15,740</td>
</tr>
<tr>
<td>Total Expendable Net Position</td>
<td>$ 14,103</td>
<td>$ 12,006</td>
<td>$ 3,244</td>
<td>$ 10,471</td>
<td>$ 22,016</td>
<td>$ 31,667</td>
<td>$ 32,310</td>
<td>$ 34,006</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>$ 175,160</td>
<td>$ 180,159</td>
<td>$ 185,742</td>
<td>$ 182,888</td>
<td>$ 181,629</td>
<td>$ 183,875</td>
<td>$ 181,740</td>
<td>$ 178,356</td>
</tr>
</tbody>
</table>

**Highlights:**

**FY08/FY09:** The low ratio in FY08 was primarily caused by the timing of funding being transferred from external sources to cover University Common construction expenses. The coverage rebound in FY09 is a result of these transfers being up-to-date and management’s efforts to increase revenues and cut operating costs.

**FY10:** USM’s ratio doubled from FY09 to FY10 primarily because of USM’s successful efforts to increase revenues and decrease expenses related to unrestricted operations (e.g., educational & general, auxiliary, and designated) and positive endowment returns (compared with negative returns in FY09) which caused a significant increase in restricted expendable net position.

**FY11:** The ratio increased again in FY11 as management successfully continued efforts to surpass the high industry benchmark for the Net Operating Revenues Ratio (see page 4) which in turn helps increase the Primary Reserve Ratio. While trying to increase expendable net position, management was cognizant of the need to invest in plant. During FY11, USM utilized $3.16 million of expendable net position on capital costs to renovate and repair existing buildings. They also utilized $2.5 million of expendable net position restricted specifically for capital investments (as previously noted, this net position is not part of the primary reserve ratio calculation).

**FY12:** Management continued to successfully balance the need to increase expendable net position with the need to invest in plant. Unrestricted expendable net position increased $1.25 million net of $4.7 million utilized on numerous renovation projects. USM also spent $3.6 million of expendable net position restricted specifically for capital investments.

**FY13:** USM’s unrestricted expendable net position changed by only $64 thousand, less than one-half of one percent. Positive endowment returns were the greatest contributor to the increase in restricted expendable net position and the primary reserve ratio. The $3.84 million decrease in expenses also contributed to the increase in the ratio; however, this contribution is somewhat artificial as it is net of a $6 million decrease in grant and contract expenses (see discussion of the net operating revenues ratio on page 5) and a $2.6 million increase in expenses for continuing activities.
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 position and, thereby, impact the other three core ratios: Primary Reserve, Return on Net Position, and Viability. This ratio is calculated as follows:

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

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.

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.

Although attainment of a positive operating return has been particularly challenging in recent years, USM’s management is ever conscious of the need for positive returns in order to increase expendable net position and align USM’s primary reserve ratio with that of the UMS and the industry benchmark.
Highlights:

With the exceptions of FY10 and FY12, USM’s operating and nonoperating revenues exclusive of revenues related to sponsored activities (e.g., grants and contracts, recovery of indirect costs, and State Fiscal Stabilization) increased in each of the past seven years.

**FY08:** USM was able to contain costs and essentially breakeven.

**FY09:** USM generated a significant positive ratio for the first time in four years. This was the result of management efforts to improve controls, increase revenues, and decrease expenses.

**FY10:** Management’s tough budgeting decisions continued in FY10 and USM increased revenues and significantly decreased expenses related to unrestricted operations (e.g., educational & general, auxiliary, and designated) which had a major impact on this ratio.

**FY11:** USM’s ratio increased again in FY11 as USM underwent organizational changes and continued to realize the financial impact of management’s tough budgeting decisions. Contributing to the FY11 results was a $1.15 million increase in noncapital State of Maine appropriation revenue that more than offset the $885 thousand decrease in State Fiscal Stabilization Program revenue.

**FY12:** Total operating and nonoperating revenues decreased $7.4 million from FY11 as USM experienced significant decreases in residence and dining fees, operating grants, and educational sales and services and the elimination of State Fiscal Stabilization Program revenue. A $2.1 million decrease in operating expenses partially offset the loss of revenues.

**FY13:** Total operating and nonoperating revenues decreased $6 million from FY12. A decrease in grant funding from the State of Maine Department of Health and Human Services and a related decrease in indirect cost recovery were primary factors for this decrease in revenues. A $3.4 million decrease in operating expenses partially offset the loss of revenues.
The **Return on Net Position 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 position. An improving trend in this ratio indicates that the institution is increasing its net position and is likely to be able to set aside financial resources to strengthen its future financial flexibility. This ratio is calculated as follows:

**Change in Net Position**

Total Beginning of the Year Net Position

Items that may impact this ratio include those that impact the net operating revenues ratio, along with endowment returns, capital appropriations, capital grants and gifts, capital transfers, and endowment gifts.

The nominal rate of return on net position is the actual return 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.
Highlights:

- State of Maine capital appropriations revenue and capital grants and gifts revenues were major factors in the nominal rate of return for several of the past eight years:
  - Although they were not enough to completely offset the loss from operations in FY06; they did help to hold the negative nominal return on net position to -.2%.
  - In FY07, these revenues along with strong endowment returns allowed USM to experience a positive return on both a nominal and real basis.
  - In FY08, these revenues were enough to offset the negative endowment returns and allow USM to experience a positive nominal rate of return.
  - In FY09, capital grants and gifts revenue reached a four year high of $11.7 million, an increase of $10.8 million over the amount for FY08. Approximately $8.5 million of this increase resulted from capital grants and gifts received for construction projects that were in progress at the end of FY08. USM was also able to increase operating revenues and decrease operating expenses in FY09.
  - In FY10 and FY11, capital appropriations and capital grants and gifts revenues were much less of a factor as they combined for a total of only $1.1 million and $1.5 million, respectively, due to a decrease in construction activity financed with gifts and the fact that most of the available State of Maine capital appropriation revenues were spent in prior years.
  - Totaling $3.5 million in FY12, capital appropriations and capital grants and gifts revenues were more of a factor than they had been in the previous two fiscal years.

- The major factor in the nominal rate for FY10 was management’s efforts to increase revenues and tough budget decisions to significantly decrease expenses related to unrestricted operations (e.g., educational & general, auxiliary, and designated).

- As with the Primary Reserve Ratio, the Return on Net Position Ratio shows the results of USM’s efforts in FY10 and FY11 to rebuild necessary reserves.

- Endowment returns, which were at a six-year high in FY11, contributed to the increased return on net position.

- The decreased return on operations in FY12 and in FY13 was the major factor in the decrease in USM’s return on net position ratio for those two fiscal years.
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:

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

* Excluding net position restricted for capital investments

Like the primary reserve ratio, the viability ratio is impacted by such items as principal payments on debt, use of unrestricted net position to fund capital construction projects, operating results (operating revenues – operating expenses + nonoperating revenues – nonoperating expenses + depreciation) and endowment returns. Issuance of new debt would also impact the ratio.

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.

A ratio of 1.00 or greater indicates sufficient resources to satisfy debt obligations.

The steady increase in USM’s viability ratio over the past five years reflects management’s efforts to increase expendable net position and reduce USM’s debt.
USM Core Financial Ratios and Composite Financial Index

Highlights:

- Issuance of new University Revenue bonds in FY07 and new internal loans from the System Office in FY08 contributed to the decline in the viability ratio for those two years.

- The following items contributed to the increase in the ratio since the low point in FY08:
  - Positive net operating revenues ratios
  - Payment of scheduled debt service on debt
  - Repayment of $2.9 million in internal loans in FY09
  - Payoff of internal loans from the System Office in FY10
  - Management decisions to avoid projects that would require debt financing
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 position 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.

The CFI is calculated by completing the following steps:

1. Compute the values of the four core ratios;
2. Convert the ratio values to strength factors along a common scale;
3. Multiply the strength factors by specific weighting factors; and
4. Total the resulting four numbers (ratio scores) to reach the single CFI score.

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.

A score of 1.0 indicates very little financial health; 3, the low benchmark, represents a relatively stronger financial position; and 10 is the top of the scale.

USM’s documented focus on debt reduction and the establishment of adequate reserves by stringent cost controls and revenue enhancements contributed to the growth in their CFI score between FY08 and FY11. During the past two fiscal years, USM’s CFI score has declined as they have experienced significant decreases in their return on operations.
### CFI Calculation

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>FY06</th>
<th>FY07</th>
<th>FY08</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
<th>FY13</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Primary Reserve Ratio</td>
<td>0.08</td>
<td>0.07</td>
<td>0.02</td>
<td>0.06</td>
<td>0.12</td>
<td>0.17</td>
<td>0.18</td>
<td>0.19</td>
</tr>
<tr>
<td>/ Common Scale Value *</td>
<td>0.133</td>
<td>0.133</td>
<td>0.133</td>
<td>0.133</td>
<td>0.133</td>
<td>0.133</td>
<td>0.133</td>
<td>0.133</td>
</tr>
<tr>
<td>= Strength Factor **</td>
<td>0.60</td>
<td>0.53</td>
<td>0.15</td>
<td>0.45</td>
<td>0.90</td>
<td>1.28</td>
<td>1.35</td>
<td>1.43</td>
</tr>
<tr>
<td>X Weighting Factor ***</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
</tr>
<tr>
<td>Ratio Score</td>
<td>0.21</td>
<td>0.19</td>
<td>0.05</td>
<td>0.16</td>
<td>0.32</td>
<td>0.45</td>
<td>0.47</td>
<td>0.50</td>
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<tr>
<td>+ Net Operating Revenues Ratio</td>
<td>-1.52%</td>
<td>-0.82%</td>
<td>0.02%</td>
<td>1.55%</td>
<td>4.67%</td>
<td>4.69%</td>
<td>2.04%</td>
<td>0.63%</td>
</tr>
<tr>
<td>/ Common Scale Value *</td>
<td>0.7%</td>
<td>0.7%</td>
<td>0.7%</td>
<td>0.7%</td>
<td>0.7%</td>
<td>0.7%</td>
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<td>0.7%</td>
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<tr>
<td>= Strength Factor **</td>
<td>(2.17)</td>
<td>(1.17)</td>
<td>0.03</td>
<td>2.21</td>
<td>6.67</td>
<td>6.70</td>
<td>2.91</td>
<td>0.90</td>
</tr>
<tr>
<td>X Weighting Factor ***</td>
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<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Ratio Score</td>
<td>(0.22)</td>
<td>(0.12)</td>
<td>-</td>
<td>0.22</td>
<td>0.67</td>
<td>0.67</td>
<td>0.29</td>
<td>0.09</td>
</tr>
<tr>
<td>+ Return on Net Position Ratio</td>
<td>-0.20%</td>
<td>3.97%</td>
<td>3.04%</td>
<td>11.69%</td>
<td>8.46%</td>
<td>8.67%</td>
<td>4.52%</td>
<td>1.72%</td>
</tr>
<tr>
<td>/ Common Scale Value *</td>
<td>2.0%</td>
<td>2.0%</td>
<td>2.0%</td>
<td>2.0%</td>
<td>2.0%</td>
<td>2.0%</td>
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<tr>
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<td>(0.10)</td>
<td>1.99</td>
<td>1.52</td>
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<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
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</tr>
<tr>
<td>Ratio Score</td>
<td>(0.02)</td>
<td>0.40</td>
<td>0.30</td>
<td>1.17</td>
<td>0.85</td>
<td>0.87</td>
<td>0.45</td>
<td>0.17</td>
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<tr>
<td>+ Viability Ratio</td>
<td>0.20</td>
<td>0.16</td>
<td>0.04</td>
<td>0.14</td>
<td>0.33</td>
<td>0.49</td>
<td>0.52</td>
<td>0.57</td>
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<td>/ Common Scale Value *</td>
<td>0.417</td>
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<td>0.417</td>
<td>0.417</td>
</tr>
<tr>
<td>= Strength Factor **</td>
<td>0.48</td>
<td>0.38</td>
<td>0.10</td>
<td>0.34</td>
<td>0.79</td>
<td>1.18</td>
<td>1.25</td>
<td>1.37</td>
</tr>
<tr>
<td>X Weighting Factor ***</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
</tr>
<tr>
<td>Ratio Score</td>
<td>0.17</td>
<td>0.13</td>
<td>0.04</td>
<td>0.12</td>
<td>0.28</td>
<td>0.41</td>
<td>0.44</td>
<td>0.48</td>
</tr>
</tbody>
</table>

**Composite Financial Index**

| 0.1 | 0.6 | 0.4 | 1.7 | 2.1 | 2.4 | 1.7 | 1.2 |

* = The common scale value is derived from the scoring scale defined by the authors of *Strategic Financial Analysis for Higher Education*, Seventh Edition for public institutions with an endowment spending rate.

** = The strength factor is the result of dividing the ratio value by the common scale value to determine a comparable value (strength) for each ratio that can be analyzed on a common scale of -4 to 10.

*** = The weighting factor is derived from the weighting schema defined by the authors of *Strategic Financial Analysis for Higher Education*, Seventh Edition for institutions with long-term debt.

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

We have overlaid the scoring scale with USM’s CFI scores for FY06 (lowest), FY11 (highest), and FY13 (current) to show the progress the University has made since FY06 and the impact of revenue challenges experienced during recent fiscal years.
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 plots actual strength factors that equal the low industry benchmark of 3 and one that plots actual strength factors that fall above and below the low benchmark:

- The center point of the graphic financial profiles is -4, the lowest possible score on the scale.
- The smaller, heavily lined diamond in the graphs represents the low industry benchmark of 3.
- The outer, lightly lined diamond represents the high industry benchmark of 10 and the highest possible score on the scale for each ratio.
- 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) industry benchmarks. In the left graph, the plotted actual values fill the smaller diamond as each of the actual values is at the low benchmark of 3. In the right graph, the smaller diamond is not filled as the actual values of two ratios fall below the low industry benchmark of 3. Also, in the right graph, part of the outer diamond is filled as values for two of the ratios surpass the low benchmark of 3.
The following graphs contain **USM’s Graphic Financial Profiles for FY06 thru FY13.**

**FY06:** All of USM’s scores were below 1 and two were below zero.

**FY07:** An inflow of State of Maine capital appropriation revenue and capital grants and gifts enabled USM’s CFI score to improve slightly in FY07; however, the strength factors for the prime reserve and viability ratios did not improve as these two revenue streams increase net position invested in plant rather than expendable net position.
**FY08**: State of Maine capital appropriation revenue and capital grants and gifts were a source of strength again in FY08, enabling USM to construct or renovate facilities, but not increase expendable net position.

**FY09**: USM experienced positive returns from both operations and total net position in FY09. The shape of the diamond in the below chart remained short; however, because the positive return on net position was primarily attributable to State of Maine capital appropriation revenues and capital grants and gifts that do not impact the prime reserve and viability ratios. The positive return from operations was offset by negative returns on endowment assets; thus, the change in the prime reserve and viability scores was minimal.
**FY10:** The return on total net position was primarily attributable to operations as the majority of available State of Maine capital appropriation and capital grants and gifts monies were expended in prior years. The strength factor for the primary reserve ratio increased only slightly as positive returns from operations and endowment assets were partially offset by management’s strategic decision to utilize expendable net position to reduce outstanding debt and to fund capital construction projects targeted to address deferred maintenance issues and refurbish existing facilities.

**FY11:** Management continued to focus on returns in order to build reserves and increase viability.
**FY12:** Although not as strong as they had been in the prior couple of fiscal years, the positive returns on operations and on net position helped to slightly increase USM’s capitalization.

**FY13:** Returns on operations and on net position decreased from the prior fiscal year, but were positive in FY13, contributing to the increase in USM’s capitalization ratios.