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Adoption of New Accounting Standard

In FY14, the University of Maine System adopted Governmental Accounting Standards Board Statement No. 65, Financial Reporting of Items Previously Reported as Assets and Liabilities (Statement No. 65), retroactive to July 1, 2012. Pursuant to the provisions of Statement No. 65, all University of Maine System campuses including the University of Maine at Machias restated their FY13 financial statements to reflect the retroactive application of this change in accounting principle. Under Statement No. 65, all bond issuance costs are now expensed in the year incurred. Pursuant to Statement No. 65, each campus 1) wrote-off its June 30, 2012 balance for bond issuance costs against the beginning of the year net position balance and 2) expensed bond issuance costs incurred during FY13. We have not recalculated the FY13 ratios included in this report for the restatement because the impact of the restatement is immaterial and it only impacts the net investment in capital assets category of net position.

Overview

The financial health of the University of Maine at Machias (UMM) 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 UMM’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:

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

* 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 .40 (provides about 5 months) or better is advisable to give institutions the flexibility to manage the enterprise.

UMM is extremely dependent on the generation of revenue to cover its expenses. Although the FY14 ratio is the highest UMM has experienced in the nine years presented, UMM’s reserves provide less than one month of expenses.
The breakdown of expendable net position between restricted and unrestricted is important in analyzing UMM’s primary ratio as restricted expendable net position must be spent in accordance with restrictions imposed by third parties and is not available to pay all operating expenses. As shown above, UMM’s unrestricted expendable net position has had a deficit balance for each of the nine years presented.

The improvement in UMM’s unrestricted expendable net position from FY13 to FY14 is primarily the result of $556 thousand of unrestricted capital transfers from the System Office during FY14 that remained unspent as of June 30, 2014. These transfers are expected to be spent on the designated construction projects during FY15. Positive endowment returns account for the FY14 increase in restricted expendable net position.

**Historical Highlights:**

**FY07 to FY09:** UMM’s expendable net position steadily declined as operating expenses steadily increased.

**FY10:** UMM significantly reduced the deficit in its expendable net position as unrestricted operating revenues increased and unrestricted operating expenses decreased. The increase in total unrestricted and restricted operating expenses is attributable to increased grant activity.

**FY11:** The FY11 endowment return was more than double the FY10 return and was the primary contributor to the increase in UMM’s total expendable net position.

**FY12:** Although total expendable net position decreased, there was an increase in unrestricted expendable net position. Negative endowment returns was the primary contributor to the decrease in restricted expendable net position.

**FY13:** UMM’s restricted expendable net position increased in FY13 as endowment returns rallied.
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:

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

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.

UMM’s net operating revenues ratio has been negative for each of the nine years presented, with the lowest point occurring in FY14 as UMM incurred a $911 thousand loss from operations.
Noncapital transfers from the System Office are part of nonoperating revenues. UMM received such transfers in each of the nine years presented and has been heavily reliant on them in recent years, having received a total of $2.5 million from FY12 to FY14. Despite receiving $1.1 million in noncapital transfers in FY14, UMM experienced a $911 thousand loss from operations as gross tuition and fees revenue decreased $531 thousand from the prior year and nongrant and noncontract expenses (operating expenses + interest expense + scholarship allowance – grants and contracts expenses) increased $223 thousand.

**Historical Highlights:**

**FY07:** From FY06 to FY07, UMM's ratio went from -2.19% to -5.77% as the increase in operating expenses outpaced the increase in operating and nonoperating revenues 3:1.

**FY08:** The increase in operating and nonoperating revenues was primarily attributable to a $289 thousand increase in net student fees, a $274 thousand increase in noncapital grant revenue, and a $345 thousand increase in noncapital State of Maine appropriation revenue.

**FY09:** UMM's ratio increased significantly from FY08 to FY09 as new federal stimulus monies were used to pay compensation and benefits that would otherwise have been paid from unrestricted operations. A 6.8% increase in operating revenues combined with only a 1.1% increase in operating expenses also contributed to the improvement in the ratio.

**FY10:** UMM's ratio again increased significantly as federal stimulus monies were again used to pay compensation and benefits that would otherwise have been paid from unrestricted operations or eliminated. Also, unrestricted operating revenues increased 3.9% and unrestricted operating expenses decreased .8%.

**FY11:** UMM's ratio decreased significantly as a 4.5% increase in expenses outpaced a 1.4% or $179 thousand net increase in revenues. Grants and contracts revenue increased $625 thousand while gross tuition and fees and educational sales and services revenues decreased.

**FY12:** UMM experienced increases in net student fees and noncapital transfers from the System Office of $379 thousand and $567 thousand, respectively. These increases were partially offset by decreases
in noncapital grants revenue and State Fiscal Stabilization Program revenue of $419 thousand and a $171 thousand, respectively.

FY12 noncapital transfers from the System Office include $271 thousand for strategic investment fund projects, $239 thousand for various noncapital construction/maintenance projects, and $172 thousand for various operating activities. Most of the $239 thousand transfer for noncapital projects remained unspent as of June 30, 2012; thus, contributing to the increase in UMM’s net operating revenues ratio from FY11 to FY12. Expenditure of these unspent monies in FY13 will have the opposite impact on the FY13 net operating revenues ratio.

**FY13**: In FY13, UMM received total operating transfers from the System Office of $708 thousand to help cover operating costs. Despite these transfers, UMM’s FY13 loss from operations was $107 thousand greater than in FY12 as UMM experienced a decline in revenues from net student fees and operating grants and contracts.
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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:

\[
\text{Change in Net Position} = \frac{\text{Total Ending Net Position} - \text{Total Beginning Net Position}}{\text{Total Beginning Net Position}}
\]

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.

The years that UMM experienced a positive nominal return on net position are the years that they received significant amounts of State of Maine capital appropriations and/or capital transfers from the System Office.
The increase in UMM’s return on net position from FY13 to FY14 is primarily attributable to a $1.1 million capital transfer from the System Office for several capital projects, including repairs to Powers Hall.

**Historical Highlights:**

Capital revenues and transfers have historically been key in offsetting in whole or in part the negative returns from operations:

- **In FY06**, the positive return on net position is attributable to a $1.5 million capital transfer from the System Office to fund deficit balances in both E&G and Auxiliary reserves. Without this transfer, the real rate of return would have been -2.1%.
- **The positive return in FY09** is attributable to an $892 thousand capital transfer from the System Office as match money on a construction project funded with State of Maine capital appropriation monies. Without this transfer, the real rate of return would have been -1.09%.
- **The positive return in FY10** is attributable to a significantly reduced loss from operations, positive endowment returns, and a $188 thousand capital transfer from the System Office to fund the Reynolds Gym boiler project. Without the capital transfer, the real rate of return would have been -.38%.
- **In FY11**, State of Maine capital appropriation revenue and significantly increased endowment returns offset the $429 thousand loss from operations and enabled UMM to recognize a small increase in net position.
- **The positive nominal rate of return on net position in FY12** is attributable to $284 thousand in State of Maine capital appropriation revenue and a $225 thousand capital transfer from the System Office to fund a scheduled jump in UMM’s debt service on the 2005 University Revenue Bonds. Without the capital transfer, UMM’s nominal rate of return would have instead been -1.27% instead of 1.21%.
- **In FY13**, UMM experienced a negative return on net position as capital revenues and transfers of $355 thousand were not enough to offset the $424 thousand loss from operations. Capital transfers from the System Office were not significant in FY13.
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.

UMM has historically had no viability with ratios that were either negative or barely above zero.
As mentioned in the discussion of the primary reserve ratio on page 3, $556 thousand of the increase in UMM’s expendable is attributable to temporarily unexpended capital transfers from the System Office.

**Historical Highlights:**

**FY08/FY09:** In addition to operating losses, the FY08 and FY09 ratios were impacted by total advances of $1.1 million on the working capital loan made to UMM by the System Office to cover UMM’s FY07 and FY08 unrestricted net position deficits.

**FY10:** Outstanding debt decreased as UMM made annual debt service payments on outstanding bonds payable and capital lease obligations.

**FY11:** An increase in expendable net position (see earlier discussion of the primary reserve ratio) combined with a reduction in debt, due to payment of annual debt service, produced a positive viability ratio for FY11. UMM last experienced a positive viability ratio in FY07. Despite this progress, UMM’s ratio is still far below the industry benchmark.

**FY12:** The decrease in UMM’s debt due to payment of annual debt service was enough to offset the impact of the FY12 decrease in expendable net position and allow UMM’s viability ratio to remain unchanged at .01. As noted in the discussion of the Return on Net Position Ratio on page 9, $225 thousand of UMM’s FY12 debt service was funded by a capital transfer from the System Office.

**FY13:** An increase in expendable net position (see earlier discussion of the primary reserve ratio on page 3) combined with a reduction in debt, due to payment of annual debt service, produced a positive viability ratio for FY13.
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.

UMM’s positive CFI scores in FY06, FY09, and FY14 are attributable to their high ratios for return on net position in those years due to large capital transfers from the System Office.
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 UMM’s lowest (FY07), highest (FY06) and most recent (FY14) scores to assist in evaluating UMM’s performance.
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.
As also occurred in several preceding years, UMM’s FY13 and FY14 strength factors for the net operating revenues ratio are at the bottom end of the scale at -4.
As noted earlier, the high return on net position for FY06 was attributable to a $1.5 million capital transfer from the System Office. UMM’s negative loss from operations in FY07 defaulted to the center of the graph. Other changes in net position were unable to completely offset the loss from operations.

Graphic Financial Profile - FY06
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of 1.9

Primary Reserve Ratio

Return on Net Position Ratio -3.13

Net Operating Revenues Ratio 0.24

Viability Ratio

Graphic Financial Profile - FY07
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of -0.7

Primary Reserve Ratio

Return on Net Position Ratio -1.82

Net Operating Revenues Ratio -4.00

Viability Ratio

Actual Low Benchmark: 3 High Benchmark: 10
All of UMM’s strength factors were negative in **FY08**, as UMM experienced another large operating loss and negative endowment returns. As noted earlier, the high return on net position in **FY09** was attributable to a significant capital transfer from the System Office. Negative operating returns again defaulted to the center of the graph.

**Graphic Financial Profile - FY08**
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of -.6

**Graphic Financial Profile - FY09**
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of .6
As noted earlier, the high return on net position for FY10 was primarily attributable to a capital transfer from the System Office. The strength factors for the two capitalization ratios remained negative and slipped to a five year low. As it did in FY07-FY09, UMM’s FY11 strength factor for its net operating revenues ratio again defaulted to the lowest plotted score of -4.

Graphic Financial Profile - FY10
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of .2

Primary Reserve Ratio

Return on Net Position Ratio

Viability Ratio

Net Operating Revenues Ratio

Graphic Financial Profile - FY11
Strength Factors Plotted on a Scale of -4 to 10
CFI Score of -.4

Primary Reserve Ratio

Return on Net Position Ratio

Viability Ratio

Net Operating Revenues Ratio

Actual □ Low Benchmark: 3 □ High Benchmark: 10
In **FY12**, UMM remained undercapitalized, having little flexibility to make organizational changes, address deferred maintenance, etc.