Austin Peay State University

Institutional Financial Performance Review

POLICIES

Issued: February 2, 2017
Responsible Official: Vice President for Finance and Administration
Responsible Office: Business Services

Policy Statement

It is the policy of Austin Peay State University that the University has a sound financial base and demonstrate financial stability sufficient to support the mission of the University over the long term.

Purpose

A sound financial base and a pattern of financial stability provide the foundation for accomplishing the University's mission, regardless of changing economic conditions. Financial and physical resources should be managed in a manner that permits the University to fulfill its mission long term.

Contents

Procedures

Responsibility

A. The chief executive officer is responsible for administering and managing the University's financial affairs in such a manner as to ensure the University's current and future financial health. This policy establishes the tools used to assess the financial health of the University, the reporting process, and actions to be taken if the University shows signs of financial weakness.

Background

A. The analytical framework contained within this policy is derived from Strategic Financial Analysis for Higher Education; Identifying, Measuring & Reporting Financial Risks; Seventh Edition, published by KPMG; Prager, Sealy & Co., LLC; and ATTAIN. This framework and its primary metric, referred to as the Composite Financial Index ("CFI"), are widely used in the higher education community to understand the financial health of institutions. The methodology, ratios, and related benchmarks contained in this policy are taken from this publication.

B. To determine the University's financial performance, four questions are asked:
   1. Are resources sufficient and flexible enough to support its mission;
   2. Does financial asset performance support the University's strategic direction;
   3. Do operating results indicate the University is living within its available resources; and
   4. Is debt managed strategically to advance its mission.

C. To address these four questions, data from the University's unaudited financial report are used to determine four "core" financial ratios that are then combined into a single composite metric of financial condition – the Composite Financial Index.

Calculation of Core Ratios and CFI

All calculations include the financial results of the University's component unit (i.e. related foundation(s), noted as "CU") to present a comprehensive picture of the University's overall financial condition. The data source for calculation of each ratio is the University's unaudited annual financial report, with all calculations reflecting the results from a single year (i.e. no use of moving averages). The four core financial ratios, including general descriptions, the calculation method, data sources, an expected performance standard, and a performance watch level and a similar description of the calculation and interpretation of the Composite Financial Index value, are as follows.

1. Return on Net Assets
   a. Description: The return on net assets ratio measures total economic return during the fiscal year. This measure is similar to the return on equity ratio used in examining for profit concerns and answers the questions, "Are they

better off financially than they were a year ago" and "Does financial asset performance support the strategic direction of the University?" While investments in plant, a capital campaign, or a poor stock market can all create year to year volatility in this measure, the trend over time should be positive.

1. Calculation:

$$\frac{\text{Change in Net Assets} + \text{CU Change in Net Assets}}{\text{Total Net Assets (beginning of year)} + \text{CU Total Net Assets (beginning of year)}}$$

b. Expected Performance Standard: The return on net assets ratio should be at least 3 percent above the rate of inflation. For example, if the Consumer Price Index (CPI) is at 3 percent, a return on the net assets ratio of 6 percent is desirable.

c. Watch Level: Consistently below the rate of inflation. Anything below the rate of inflation indicates a reduction of the University's asset base in real dollars, thereby eroding the purchasing power of the University resources for future generations.

2. Net Operating Revenues Ratio

a. Description: The net operating revenues ratio indicates an operating surplus or deficit in the given fiscal year. A positive ratio indicates that the University experienced an operating surplus for the year. This ratio is similar to a profit margin and answers the questions, "Did they balance operating expenses with available revenue" and "Do the operating results indicate that the University is living within available resources?" Depreciation expense is included to reflect the use of physical assets in measuring operating performance.

1. Calculation:

$$\frac{\text{Operating Income (Loss)} + \text{Non-operating Revenues (Expenses)} + \text{CU Change in Unrestricted Net Assets}}{\text{Operating Revenues} + \text{Non-operating Revenues} + \text{CU Total Unrestricted Revenue}}$$

b. Expected Performance Standard: A ratio of 4.0%. This is considered adequate to keep pace with the growth in operating expenses and maintain reserves at acceptable levels.

c. Watch Level: Consistently below zero. A deficit in a single year does not necessarily indicate a problem, but deficits over several years are a cause for concern and suggest that the University's mission cannot be sustained and University finances should be restructured.

3. Primary Reserve Ratio.
   a. Description: The primary reserve ratio measures financial strength and flexibility by comparing expendable net assets to total expenses. This measure answers the question, “How long can the University survive without additional net assets generated by operating revenue?”
      1. Calculation:

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

   b. Expected Performance Standard: A ratio of 0.40 (representing about 5 months of expenses) or higher. At this level the University has the flexibility to manage minor financial disruptions and other unforeseen events with less need to immediately disrupt ongoing activities. At this level, the University can be expected to carry on a reasonable level of facilities maintenance activities.
   c. Watch Level: A ratio of 0.133 (represents less than 1.5 months of expenses in ready assets) or less. If the University is at this level, it will have less operating flexibility to meet unexpected events, generally lack sufficient resources to pursue strategic initiatives, and may struggle to invest in plant maintenance.
4. Viability Ratio
   a. Description: The viability ratio measures the financial health of the University by comparing total expendable net assets to total current and non-current liabilities. This ratio is similar to a coverage ratio used in the private sector to indicate the ability of an organization to cover its long term debt from readily available resources and answers the questions, “How much of their debt can the University pay off with existing resources” and “Is debt managed strategically to advance the University's mission”. If the University has no debt, this ratio is ignored in the calculation of the CFI score. A ratio of 1.0 indicates the University has expendable resources sufficient to satisfy all outstanding plant related debt.
      1. Calculation:

$$\frac{\text{Expendable Net Assets + CU Expendable Net Assets}}{\text{Plant Related Debt + CU Plant Related Debt}}$$

   b. Expected Performance Standard: A ratio of 1.25 or higher (the higher the ratio, the stronger the credit-worthiness of the University). At these levels, the University has increased flexibility to address unexpended events.

c. Watch Level: A ratio of 0.41 or less. Similar to the primary reserve ratio Watch level, the University at this level will have decreased flexibility to respond to unforeseen events, essentially a reduced “margin of error” in the financial management of the University. Dropping below a ratio of 0.41 may identify the University as a credit risk.

Composite Financial Index (CFI)

A. After their calculation, these four ratios are combined to deliver a single measure of the overall financial health of the University. By blending these four core financial ratios into one metric, a more balanced view of the University’s finances is provided since weakness in one measure can be offset by strength in another. Additionally, measuring the index over time provides a glimpse as to the progress the University is making toward achieving financial goals. CFI scores range from a low of -4.0 to a high of 10.0. The CFI is computed using a four-step methodology:

1. Computing the values of the core ratios as outlined above;
2. Calculating strength factors by dividing the core ratios by threshold values;
3. Multiplying the factors by specific weights; and
4. Totaling the resulting scores to obtain the composite financial index.
   a. University (Outstanding Debt):

Core Ratio Value		Threshold Value		Strength Value		Weight		Score
Return on Net Assets	/	0.02	=	0	x	20%	=	0
Net Operating Revenues	/	0.013	=	0	x	10%	=	0
Primary Reserve	/	0.133	=	0	x	35%	=	0
Viability	/	0.417	=	0	x	35%	=	0
		Composite Financial Index Score					**=**	**0**

B. Expected Performance Standard: A score of at least 3.0. Strategic Financial Analysis for Higher Education indicates that at this level the University is relatively financially healthy in that sufficient liquid resources exist to meeting unforeseen circumstances, net operating revenues are adequate, expendable net assets exceed the level of debt, and the return on net assets is reasonable.

C. Watch Level: A score of 1.0 or less. Again, Strategic Financial Analysis for Higher Education suggest that scores of 1.0 or below call into question the University's ability to carry out existing programs and survive.

Review Periods

A. While important, the Board acknowledges that annual results should be placed in context by reviewing longer terms trends. By focusing on 3 to 5 year trends, the Board believes the long term financial health of the University may be better ascertained.

Process for Reporting

A. Within thirty days of issuance of published financial statements, the University's chief business officer shall be responsible for calculation of the University's core ratios and CFI score and submitting this information to the President of the University. As part of this submission, the chief business officer shall provide a narrative that explains the factors underlying changes in ratio values and CFI scores from the prior year, and whether these factors were planned or unexpected. If Watch Level performance is evidenced on any indicator, the submission shall also address what action the University plans to take to improve the ratio or score in subsequent years.

B. For any measure that evidences Watch Level performance, the President will review with the chief business officer the adequacy of the University's plan to address the issue.

C. On an annual basis, the Board shall be advised on the aggregate overall financial performance of the University. The President through the chief business officer shall report to the Board if the University's performance meets the Composite Financial Index Watch Level criteria specified in this policy.

Revision Dates

APSU Policy 4:020 – Issued: February 2, 2017

Subject Areas:

Academic	Finance	General	Human Resources	Information Technology	Student Affairs
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Approved

President: signature on file