

# MINNESOTA STATE COLLEGES AND UNIVERSITIES BOARD OF TRUSTEES

## Agenda Item Summary Sheet

**Committee:** Finance, Facilities and Technology **Date of Meeting:** September 17, 2008

**Agenda Item:** Reserves Discussion

☐

Proposed  
Policy Change

☐

Approvals  
Required by  
Policy

☐

Other  
Approvals

☐

Monitoring

☒

Information

**Cite policy requirement, or explain why item is on the Board agenda:** The purpose of this Board report is to provide financial information to the Finance, Facilities and Technology committee as background information for a discussion of Board required reserves (a designated cash reserve as currently required under Board Policy 5.10 and related procedure 5.10.1) and full accrual reserves using the common financial ratio measure of primary reserve and the number of months of operating expenses represented by this primary reserve measure.

**Scheduled Presenter(s):** Laura M. King, Vice Chancellor—Chief Financial Officer  
Judy Borgen—Associate Vice Chancellor, Budget Unit  
Tim Stoddard—Associate Vice Chancellor, Financial Reporting

**Outline of Key Points/Policy Issues:** Minnesota State Colleges and Universities (the System), and the component colleges and universities are required under Board Policy 5.10 and Procedure 5.10.1 to maintain general fund cash reserves in the range of 5 – 7 percent of general fund cash-basis operating revenues through designation as a special reserve amount.

Unlike the Board required reserve, the primary reserve is a full-accrual accounting measure that compares expendable net assets (relatively liquid net assets) to the sum of annual operating expenses plus interest expense. This percentage value multiplied times twelve months yields the number of months of operating expenses that that can be covered through use of the expendable net asset balance.

Questions regarding reserves such as what levels of Board reserves and primary reserves are adequate, how should reserves be measured, what steps should be taken to move all colleges and universities to a defined or target level, are ultimately part of policies, procedures and guidelines directed at setting financial management policies and the goals thereof. Reserves are a key component.

**Background Information:** This discussion on reserves is in response to the referral of the discussion by the Audit Committee to the Finance, Facilities and Technology Committee.

**BOARD OF TRUSTEES  
MINNESOTA STATE COLLEGES AND UNIVERSITIES**

<b>INFORMATION ITEM</b>
<b>Reserves Discussion</b>

## **BACKGROUND**

The purpose of this Board report is to provide background information and data to the Finance, Facilities and Technology committee for purposes of a discussion about reserves. Although measured differently, financial reserves are represented by both Board required reserves (designated fund balances—a designation of yearend general fund cash) and primary reserves (a full-accrual measure including all funds that first subtracts total liabilities from total assets and compares the liquid component of net assets to operating expenses).

Regardless of which reserve measure is used, there are wide variances across the system’s colleges and universities. Reserves are typically expected to cover operational and strategic objectives. That is, reserve balances provide resources to assist an organization maintain operations for some period in spite of adverse financial conditions, and if adequate, reserves can provide opportunity funds to pursue innovative, strategic programs. Ideally, reserves are adequate to provide operational and strategic support consistent with financial management policies and related goals.

Reserves are created over time through intentional financial management. Positive annual operating results are accumulated year-by-year as part of and in accordance with financial management goals. Assessment of operational risks plays a key role in determining a reasonable level of operational reserves, assessment of strategic needs and opportunities (e.g., socio/economic, market, technology, and others) determines a reasonable level of strategic reserves, and economic and operational realities present constraints and challenges that will impact reserve levels and the timing of reserve accumulation.

A committee presentation will be made by Judy Borgen, Associate Vice Chancellor of Budget, and Tim Stoddard, Associate Vice Chancellor of Financial Reporting.

## **CONTENTS**

1. Executive summary
2. Current policies, procedures and guidelines covering financial management components
3. Comparing Board required reserve and primary reserve
4. External views on primary reserves
5. Summarized Board and primary reserve values for the System’s colleges and universities
6. Dynamics associated with increasing Board reserves and primary reserves
7. Next steps

## 1. Executive summary

- Financial management policies generally have operational and strategic objectives and will provide direction to management, allow assessment and drive specific goals and behavioral expectations. For example, a reserve is operational (e.g., continuity of operation in the face of revenue interruption) and strategic (e.g., fund new, innovative strategic programs).
- Board Policy 5.10 and Procedure 5.10.1 set requirements for designated cash reserve levels; Procedure 5.10.1 recognizes the full-accrual financial measure of net assets as a broader measure of financial condition, but it does not set full-accrual reserve guidelines.
- Increasing the Board required cash reserve from the current average 5 percent to a 10 percent level for all colleges and universities over a five year period would require adding approximately \$65.3 million of additional designated fund balance to the June 30, 2007 balance of \$63.1 million.
- Increasing the primary reserve from the current 2.5 months to 3.0 months of operating expense at a consolidated system level over the same five year period would require additional net operating margin of approximately \$67.1 million; increasing each additional month thereafter would require about \$128 million.
- **Key questions**
  - What levels of Board reserves and primary reserves are adequate and how should this be defined?
  - What steps should be taken to move all colleges and universities to a defined or target level?

## 2. Current policies, procedures and guidelines covering financial management components:

- Include
  - Required cash reserves
  - Annual external financial statement audits of 7 state universities, 5 colleges, the Revenue Fund and the consolidated system
  - Financial Trends and Highlights since fiscal year 2006 including Composite Financial Index and other measures coupled with steps to increase the use and understanding of accrual financial data by all colleges and universities. (See Attachment 1 for a summary and an example presentation format).
  - Operational and compliance audits by Offices of Internal Audit and the Legislative Auditor
  - Balanced budgets
  - Revenue Fund and other auxiliary operations are subject to various Board or Revenue Fund policy/procedure requirements related to reserve requirements tied to months coverage of operating expenditures
- Do not include:
  - Goals for improving financial condition (e.g., strengthening primary reserve)
  - Financial profile components and target values or range (e.g., positive operating margin)

## 3. Comparing Board required reserve and primary reserve are quite different

- Board required reserve
  - Board Policy 5.10 requires a reserve of between 5% and 7%
  - It is a cash reserve—a designation of fund balance
  - It looks at general fund balance as a percentage of prior year general fund revenue

- Primary reserve
  - Primary reserve has no standing in Board Policy, Procedure or Guideline
  - Primary reserve is a common, enterprise-wide (all funds) financial ratio
  - It includes all accrued assets and liabilities (i.e., assets – liabilities = net assets)
  - It compares expendable net assets (relatively liquid) to the sum of operating expenses (including depreciation on capital assets) plus interest expense
  - It approximates the number of months that operations could continue despite a temporary halt in revenue
- Comparative example: Assume that at 6/30/08 XYZ Community College had only one asset, a cash balance of \$1,000,000, and only one liability, compensated absences payable of \$1,000,000. Further assume that XYZ designated \$500,000 of the cash balance as required reserve (Board required reserve).
  - Board required reserve = \$500,000 (e.g., 5% of prior year general fund operating revenue)
  - Primary reserve = 0.0 months--XYZ has zero net assets (cash of \$1million minus compensated absence liability of \$1million) so the numerator in the primary reserve calculation is zero.

#### 4.External views on primary reserves.

*Strategic Financial Analysis for Higher Education* (Sixth Edition), jointly developed and sponsored by the firms of Prager, Sealy & Co., LLC, KPMG LLP and BearingPoint, Inc., a highly respected source for financial analysis in Higher Education, views 5.0 months of primary reserves as indicative of an institution with solid financial condition.

Moody's Investor Services (Moody's) annual report titled *Public College and University Medians 2007* contains primary reserve median values organized by credit rating level. The table directly below summarizes the various credit rating levels into two combined levels and presents the range of values within the summarized levels. Note that the median value for all institutions in the population is nearly constant at 5.0 months coverage of operating expenses. Although coincidental, it does match well with the value above from *Strategic Financial Analysis for Higher Education* (Sixth Edition). The system-wide median value is indicated in bold type.

Number of Months Primary Reserve – Moody's Median Values				
Credit Rating Level	# orgs	<u>2006</u>	<u>2005</u>	<u>2004</u>
Aaa/Aa1/Aa2/Aa3 (range)	58	5.6 - 12.1	5.8 - 9.5	5.5 - 8.8
A1/A2/A3/Baa (range)	144	2.8 - 4.8	2.3 - 4.8	2.5 - 4.7
<b>MnSCU (2.5 in 2007)</b>		<b>2.3</b>	<b>2.1</b>	<b>2.1</b>
Median for all	202	5.0	5.0	4.9

Moody's national data population includes a wide range of public institutions (202 institutions), including Research I institutions, and some institutions very large foundations as component units. Two-year colleges are not included (except for those included in a system) and certain of the organizations may only include discreet parts (e.g., MnSCU Revenue Fund). The presence of these significant variables suggests the results are not strictly comparable in all respects to the Minnesota State Colleges & Universities system. However, the relatively large population size should smooth some of the peculiarities such that the data is still informative.

## 5. Summarized Board and primary reserve values for the System's colleges and universities

### A. Board required reserve -

- Fiscal year 2008 estimated Board required reserves, measured as a percentage of fiscal year 2007 general fund operating revenue, averages 5% and ranges from 2% to 7% across the colleges and universities.
- Increasing the Board required cash reserve from the current average 5 % to a 10 % level for all colleges and universities over a five year period would require adding approximately \$65.3 million of additional designated fund balance to the June 30, 2007 balance of \$63.1 million. The table below shows the additional \$65.3 million reserves summarized by current level.

Board Required Reserve Colleges/Universities at:	\$ (thousands) Needed to Reach 10%		
	<u>In 5 years</u>	<u>Per Year</u>	<u>C/U</u>
Two percent	\$2,973	\$595	1/0
Three percent	\$17,458	\$3,492	1/4
Four percent	\$6,730	\$1,346	2/1
Five percent	\$21,760	\$4,352	11/1
Six percent	\$10,290	\$2,058	4/1
Seven percent	\$6,082	\$1,216	6/0
Totals	\$65,293	\$13,059	25/7

### Primary Reserves

- The fiscal year 2007 primary reserve in number of months operating expense coverage ranges from a low of 0.22 months to a high of 4.24 months.
  - Increasing the primary reserve from the current 2.5 months to 3.0 months at a consolidated system level would require additional net operating margin of approximately \$67.1 million
  - Increasing each additional month thereafter would require about \$128 million
- The table below shows four primary reserve value groupings and includes several measures assessing the degree of difficulty in moving to the next higher primary reserve level

Primary Reserve Groupings & (# C/U)	2007 Avg	FTE	3 Yr Average Annual (\$000)	Total (\$000) need for	Total \$ need at left as average % of:	
	# Mos	Students	Op. Margin	Next Level	Oper. Exp	Tuition/Fee
< 1.0 mo (10/0)	0.70	17,918	\$ (970)	\$ 5,213	2.6%	6.4%
> 1.0 and < 2.0 mo (6/2)	1.47	27,748	\$ (833)	\$ 14,012	4.6%	10.2%
> 2.0 and < 3.0 mo (6/4)	2.34	58,873	\$ 16,024	\$ 36,029	5.8%	11.7%
> 3.0 and < 4.4 mo (7/1)	3.44	31,300	\$ 13,990			
System-wide @ 3.0 *				\$67,000		
Each additional 1.0 month*				\$128,000		

\* Inclusive of system primary reserve balance

### 6. Dynamics associated with increasing Board reserves and primary reserves.

- Revenue increases vs. affordability and access
- Cost decreases vs. maintaining quality, innovation, deferred maintenance, etc.
- Structural or near-structural deficits at some institutions vs. few realistic options
- Perception of and resistance to assets held as a reserve, primarily cash

### 7. Next Steps

- The Office of the Chancellor Finance Division will work with the nine colleges and universities, who are currently below the general fund reserve minimum, to assess their plans to replenish reserves to the Board required level of 5% to 7%. An update will be presented to the Board of Trustees at the time the FY2010 operating budget is presented for approval.
- The Office of the Chancellor Finance Division will work to establish a guideline formulating accrual-based financial measures building on the Division's yearend Financial Trends and Highlights reporting for all colleges and universities through continuous improvement. This will include:
  - Operating margin targets and related definitions
  - Primary reserve targets and related definitions
  - Other accrual based measures and definitions for financial condition or operations as determined appropriate

*Date presented to the Board of Trustees: September 17, 2008*

## Financial Trends and Highlights

Starting with the fiscal year 2006, the twelve audited colleges and universities have been preparing a “Financial Trends and Highlights” document using common guidelines and performance measures applied to the full-accrual statements. This annual “financial check-up” has been and continues to be presented by the institutions’ leadership teams at the audit exit meetings. The colleges not subject to external audits of financial statements prepared this document for fiscal year 2007 and the respective CFOs presented the information to campus and system office peers at one of two informal meetings held this past January. The fiscal year 2008 presentations will include the respective presidents of the non-audited colleges.

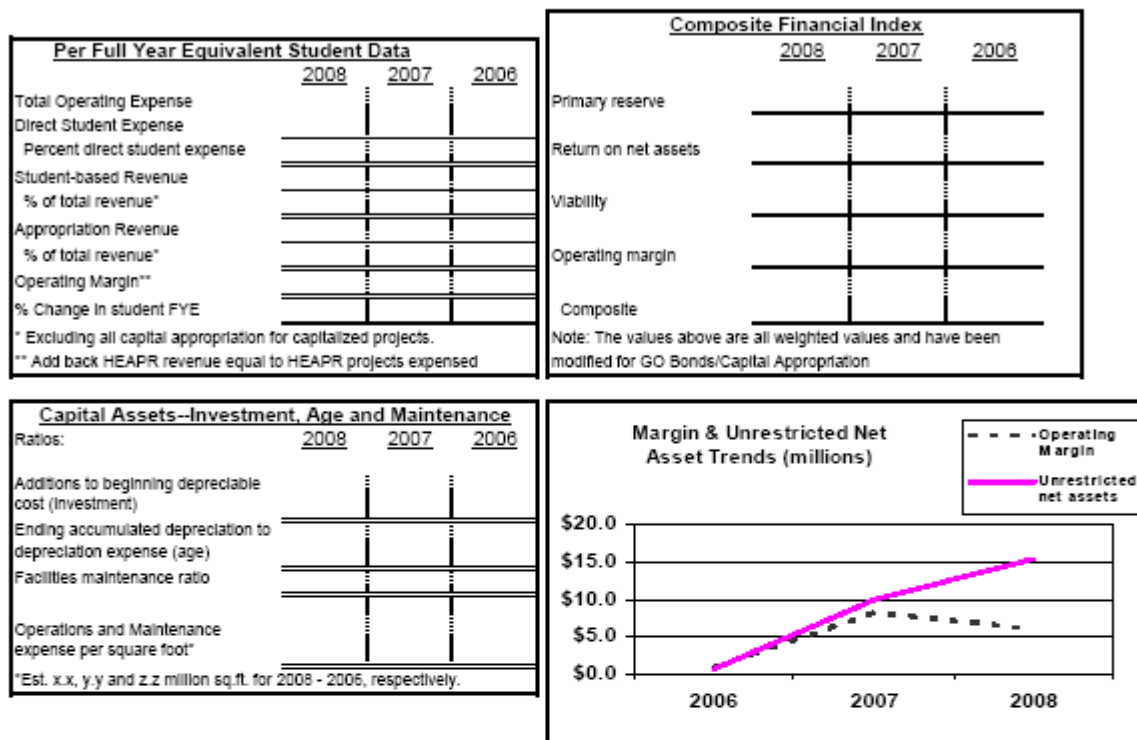
Financial Trends and Highlights reporting of common and supplemental measures across system institutions over a period of comparative years will allow us to 1) establish individual benchmarks by institution to assess financial health, 2) develop a common understanding of the measures themselves, including the economic factors most prone to produce significant positive or negative change, and perhaps most important, 3) link college and university strategic and programmatic planning to long-term financial planning and financial health. It is this last objective that will facilitate the identification and planning of the future actions necessary to achieve the level of financial health required to support the college’s or university’s mission.

The following page includes the generic Financial Trends and Highlights template; however, innovation as to format and supplemental content is encouraged.

## Financial Trends and Highlights

[Insert college/university name]  
Fiscal Year 2008 Financial Trends and Highlights

Template



### Summary of Financial Expectations and Performance

#### Discuss Current Financial Health

Assess how the college's or university's current financial health has positively or negatively impacted core mission in fiscal year 2008. Did financial health, as measured by the Composite Financial Index performance indicators and other indicators on the financial trends and highlights summary, improve or deteriorate and why? See the *Fiscal Year 2008 Financial Trends and Highlights Preparation Guidelines* for additional suggestions.

#### Discuss Plans that will Impact Future Financial Health

Discuss the appropriateness of the college's or university's mission and strategic goals in light of current financial health, steps designed to increase financial health, programs expected to be funded by expendable net assets (i.e., reserves), etc. In other words, looking ahead from early fiscal year 2008, how well matched are mission, strategic goals, and financial resources? If necessary, what steps are planned to bring about better alignment? See the *Fiscal Year 2008 Financial Trends and Highlights Preparation Guidelines* for additional suggestions.





## Reserves Discussion

**Finance, Facilities and Technology Committee  
September 16, 2008**

The Minnesota State Colleges and Universities system is an Equal Opportunity employer and educator.



## Key Questions

- What levels of Board reserves and primary reserves are adequate and how should this be defined?
- What steps should be taken to move colleges and universities to a higher level of Board reserves and define a target level for primary reserves?

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## Next Steps

- The Office of the Chancellor Finance Division will:
  - Work with the nine colleges and universities, who are currently below the general fund reserve minimum, to assess their plans to replenish reserves to the Board required level of 5% to 7%. An update will be presented to the Board of Trustees at the time the FY2010 operating budget is presented for approval.
  - The Office of the Chancellor Finance Division will work to establish a guideline formulating accrual-based financial measures building on the Division's yearend Financial Trends and Highlights reporting for all colleges and universities through continuous improvement. This will include :
    - Operating margin targets and related definitions
    - Primary reserve targets and related definitions
    - Other accrual based measures of financial condition or results as determined appropriate

Slide 3



## Goal of Financial Management Policies

- Provide direction for Financial Management action (e.g., steps to increase reserves)
- Allow assessment of financial condition (e.g., inadequate, adequate, strong, etc.)
- Provide a basis for setting specific goals and behavioral expectations (e.g., short-term actions and longer-term strategic directions)

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## Current System Policies

- Policy 5.10 sets a General Fund cash reserve requirement of 5% - 7% of prior year's general fund operating revenues.
- Current Board full external audit requirement is 12 colleges/universities, Revenue Fund and consolidated System.
- Balanced budgetary (cash) basis budgets are required; designated cash reserves may be used per delegated authority.
- Procedure 5.10.1 recognizes the full-accrual financial measure of net assets, but it does not set full-accrual reserve guidelines.

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## Missing Components

- Goals for improving financial condition (e.g., specific reserve milestones).
- Financial profile targets, specific components and value expectations.
  - Board reserves
  - Primary reserve
  - Operating margin
  - Direct/indirect spending on students
  - Other

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## Board Required Reserve Overview

- \$65.3 million additional designated cash reserves needed to bring all C/Us to 10% level from current \$63.1 million 5% average

Colleges/Universities	\$ (thousands) Needed to Reach 10%		
	In 5 years	Per Year	Number C/Us
Two percent Board reserves	\$2,973	\$595	1
Three percent Board reserves	\$17,458	\$3,492	5
Four percent Board reserves	\$6,730	\$1,346	3
Five percent Board reserves	\$21,760	\$4,352	12
Six percent Board reserves	\$10,290	\$2,058	5
Seven percent Board reserves	\$6,082	\$1,216	6
Totals	\$65,293	\$13,059	32

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## External view of Primary Reserve

- The Moody's Investor Services data in the table below shows a median value of 5.0 months but comparability is marginal

Number of Months Primary Reserve – Moody's Median Values				
Credit Rating Level	# orgs	2006	2005	2004
Aaa/Aa1/Aa2/Aa3 (range)	58	5.6 - 12.1	5.8 - 9.5	5.5 - 8.8
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Median for all	202	5.0	5.0	4.9

- *Strategic Financial Analysis for Higher Education* (Sixth Edition), jointly developed and sponsored by the firms of Prager, Sealy & Co., LLC, KPMG LLP and BearingPoint, Inc., a highly respected source for financial analysis in Higher Education, views 5.0 months of primary reserves as indicative of an institution with solid financial condition.

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## Primary Reserve Overview

- System C/Us range from 1 week to > 4 mos
- Raising the system-wide average to 3.0 months would take \$ 67 million; each additional 1.0 month about \$128 million.\*

Primary Reserve Groupings & (# C/U)	2007 Avg	FTE	3 Yr Average Annual (\$000)	Total (\$000) need for	Total \$ need at left as average % of:	
	# Mos	Students	Op. Margin	Next Level	Oper. Exp	Tuition/Fee
< 1.0 mo (10/0)	0.70	17,918	\$ (970)	\$ 5,213	2.6%	6.4%
> 1.0 and < 2.0 mo (6/2)	1.47	27,748	\$ (833)	\$ 14,012	4.6%	10.2%
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> 3.0 and < 4.4 mo (7/1)	3.44	31,300	\$ 13,990			
System-wide @ 3.0 *				\$67,000		
Each additional 1.0 month*				\$128,000		

\* Inclusive of system primary reserve balance

\* Based on June 30, 2007 expendable net assets of \$318 million; this ignores increases in operating expenses.

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## Example: Board VS Primary Reserve

- Comparative example: Assume that at 6/30/08 XYZ Community College had only one asset, a cash balance of \$1,000,000, and only one liability, compensated absences payable of \$1,000,000. Further assume that XYZ designated \$500,000 of the cash balance as required reserve
  - Required reserve = \$500,000 (assume this is 5% of prior year general fund operating revenue)
  - Primary reserve = 0.0 months--XYZ has zero net assets (cash of \$1million minus compensated absence liability of \$1million) so the numerator in the primary reserve calculation is zero.

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