

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

**Agenda Item Summary Sheet**

**Committee:** Finance, Facilities and Technology      **Date of Meeting:** January 19, 2010

**Agenda Item:** FY2009 and FY2008 Audited Financial Statements

- 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 present to the Finance, Facilities and Technology Committee of the Board of Trustees the audited financial report for the Minnesota State Colleges and Universities for the year ending June 30th 2009 and 2008 and the results of individual institutions financial statement audits.

**Scheduled Presenter(s):** Laura M. King, Vice Chancellor - Chief Financial Officer  
Tim Stoddard, Assistant Vice Chancellor Financial Reporting

**Outline of Key Points/Policy Issues:** The system wide audit, revenue fund audit and the twelve individual college and university audits received unqualified opinion letters from the respective audit firms. The opinion letters provide the Board and other users of the financial statements with assurance that the information is accurate and reliable in all material respects.

FY2009 operating results yielded a modest improvement in financial position at June 30, 2009. Net assets increased \$107 million or 7.4 percent; the increase was due to FY2009 capital appropriation revenue of \$107 million that funded capital asset investment, preservation and replacement. Income before other revenues, expenses, gains or losses, also termed "net operating revenue," decreased from a positive \$8 million in FY 2008 to a negative (\$9) million in FY 2009. This negative net operating revenue is the net of \$1,734 million of operating and nonoperating revenues less \$1,743 million of operating and nonoperating expenses.

The Statements of Net Assets, often referred to as the balance sheet, mirror the year's financial results with modest growth in assets and liabilities during FY2009. The Primary Reserve measure remained constant at 2.5 months of operating expenses for the third consecutive year.

**Background Information:** The financial statements were prepared by the Finance division of the Office of the Chancellor with the assistance of the campus Finance departments and have been audited by the firm of Kern, DeWenter, Viere, Ltd.

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

**FY2009 Audited Financial Statements**

**BACKGROUND**

The purpose of this Board report is to present to the Finance, Facilities and Technology committee of the Board of Trustees the audited, consolidated financial statements for the Minnesota State Colleges and Universities for the years ending June 30, 2009 and 2008. These financial statements were prepared by the Finance division of the Office of the Chancellor with the assistance of the campus Finance departments and have been audited by the firm of Kern, DeWenter, Viere, Ltd. This is the last year of a second consecutive three year contract with Kern, DeWenter, Viere, Ltd. as the system auditor. These statements were presented to the Audit Committee by the Finance division and Kern, DeWenter, Viere, Ltd., at the November 18, 2009 Audit Committee meeting.

**AUDIT RESULTS**

The system wide audit, revenue fund audit and the twelve individual college and university audits received unqualified opinion letters from the respective audit firms. The opinion letters provide the Board and other users of the financial statements with assurance that the information is accurate and reliable in all material respects.

The three external audit firms presented their respective results of audits, including audit opinions, internal control matters and other required communications at the November 18 Audit Committee meeting. In addition, the three audit firms communicated results of internal control assessments in writing to the Board of Trustees.

In the Report on Internal Control over Financial Reporting and on Compliance and Other Matters based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards, Kern, DeWenter, Viere, Ltd, cited two significant internal control deficiencies. A “significant deficiency” is an internal control deficiency or combination of deficiencies that based on auditor judgment may have more than a remote likelihood of failing to prevent or detect a misstatement that is more than inconsequential to the financial statements. It is important to note that no financial statement errors were detected due to these deficiencies nor were any financial statement adjustments proposed or processed. The two significant deficiencies cited follow:

Significant deficiency 2009-01 Systemwide Information Technology:

Condition: “MnSCU has not fully developed a process to adequately address prior year Information Technology comments that are essential to data security and business continuity in a timely manner, and MnSCU has not implemented adequate user level security over current web application environments.”

Recommendation: Kern, DeWenter, Viere, Ltd, recommend “MnSCU develop a comprehensive process for addressing Information Technology comments. The process should categorize, prioritize, assign responsibility, establish timelines and monitor results to ensure resolution of these comments.”

Management’s Response: The Office of the Chancellor will develop a comprehensive reporting process to ensure Information Technology audit comments are resolved in a timely manner.

Significant deficiency 2009-02 Reconciliation of Local Campus Bank Accounts:

Condition: “MnSCU has not reconciled all local campus bank accounts in a timely and accurate manner at June 30, 2009.”

Recommendation: Kern, DeWenter, Viere, Ltd, recommend “that all campus local bank accounts be reconciled on a timely basis. To accomplish this recommendation, we recommend additional training be provided at the campus level to accurately complete bank reconciliations in a timely manner, and that the Office of Chancellor continue to monitor timely reconciliation compliance and reporting. We also recommend that the Office of Chancellor consider allocating additional resources to assist in the reconciliation process through increased campus assistance or coordination of shared campus services.”

Management’s Response: The Office of the Chancellor will work with the Colleges and Universities to reconcile all local bank accounts on a timely basis and consider allocating additional resources to the campuses if necessary.

Kern, DeWenter, Viere, Ltd, also issued a separate management letter for the system wide statements. This letter contained comments on matters deemed less significant under audit standards including internal controls, accounting, administration and operating matters. Management agrees with and will take the necessary steps to respond to the observations made in the management letter.

The Revenue Fund and twelve individual college and university financial statements have been incorporated into the consolidated system wide financial statements along with the financial statements of the unaudited colleges. The Audit Committee members spent considerable individual time reviewing the various annual financial reports prior to the formal meeting. The two hour formal Audit Committee meeting generated good

discussion based on Trustees' questions. The Audit Committee recommended release of the audited statements, a motion that was approved by the full Board of Trustees at the November 19, 2008 meeting.

All audited financial reports may be viewed on the system's website at:

<http://www.finance.mnscu.edu/accounting/financialstatements/index.html>

## INFORMATION

The system wide financial report for fiscal years 2009 and 2008 is presented in accordance with Statement No. 35 *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities* as established by the Governmental Accounting Standards Board (GASB). The system's financial information is presented in one column form as a "Business Type Activity". The resources are still governed by the governmental fund based principles and continue to be accounted for in the general, special revenue, enterprise, and revenue funds. Fund level information can be found in the financial statement supplemental schedules contained in a separate report (unaudited) titled "*Supplement to the Annual Financial Report for the year ended June 30, 2009.*" This supplemental report also contains financial statements for each college and university.

All university foundations plus the Century College Foundation and Fergus Area College Foundation are separately included in the related institutions' financial reports and the system's financial report. Reporting standards require the inclusion of component entities if found to be "significant" to the primary organization. The foundations and their auditors are very cooperative in adjusting their audit schedules in order to conform to the system's financial reporting audit schedule.

### Summary of Financial Results

Fiscal year 2009 operating results yielded another modest improvement in financial position at June 30, 2009 despite a small net operating revenue loss.

- Net assets increased \$106.8 million or 7.4 percent; most of the increase was due to fiscal year 2009 capital appropriation revenue of \$106.7 million that funded capital asset investment, preservation and replacement.
- Income before other revenues, expenses, gains or losses, also termed "net operating revenue" further below, decreased from a positive \$8.4 million in fiscal year 2008 to a loss of \$(9.3) million in fiscal year 2009. This net operating revenue loss is the net of \$1,734.3 million of operating and nonoperating revenues less \$1,743.6 million of operating and nonoperating expenses.
- Capital appropriation revenue of \$106.7 million plus other capital asset related revenue offset the \$(9.3) million net operating revenue loss and generated a change in

net assets of \$106.8 million, a slight decrease from the \$119.9 million change in net assets generated in fiscal year 2008.

### **Consolidated Statements of Net Assets**

The primary driver of change within the Statements of Net Assets between June 30, 2009 and 2008 is capital asset development and renewal activity related to the system's 26 million plus square feet of academic and administrative buildings.

- New construction in progress of \$192.4 million was the primary factor increasing the capital assets balance, net of depreciation, by \$132.8 million
- Capital asset financing came primarily from \$106.7 million of capital appropriation and \$71.0 million of new long-term debt
- Net assets (e.g., net worth) increased \$106.8 million including a \$92.2 million increase in net assets invested in capital assets, net of related debt

### **Consolidated Statements of Revenues, Expenses and Changes in Net Assets**

Fiscal year 2009 operating expenses of \$1,717.3 million averaged \$4.7 million per day when divided by 365 days. Looking at the operating expense number in relation to liquid assets, the system's \$572.3 million of unrestricted cash and equivalents plus unrestricted investments would be adequate to cover approximately 4.2 months of expenses, a decrease of 0.3 months from fiscal year 2008.

- Revenue sources funding operations included \$743.2 million of state appropriation and grants, \$730.1 million of student payments, net, \$216.5 million of federal grants, and \$44.5 million of other revenue
- Expenses supporting operations included \$1,224.8 million of compensation, \$220.5 million of purchased services (utilities, enterprise and other IT support, etc.), \$89.6 million of supplies, \$83.0 million of depreciation and other expenses of \$125.7 million

### **Measuring Financial Health-- Composite Financial Index (CFI)**

#### ***What is CFI?***

The Composite Financial Index calculation uses four financial ratios and assigns a specific weighting to each factor in computing a single, composite measure of financial health. The CFI methodology is contained within the *Strategic Financial Analysis for Higher Education* (Sixth Addition), jointly developed and sponsored by the firms of Prager, Sealy & Co., LLC, KPMG LLP and BearingPoint, Inc. This CFI calculation methodology is also used by the Higher Learning Commission as a gauge of member institutions' financial health. Without detailing the actual calculation methodology, financial ratio values are converted into strength factors which in turn are weighted to allow summing of the four components into a single, composite value.

The *primary reserve ratio* and *viability ratio* are measures of financial condition based on expendable net assets found on the Statement of Net Assets with each weighted 35 percent in the composite calculation. The *net operating revenues ratio* and *return on net assets ratio* are measures of financial performance based on results contained within the statements of revenues, expenses, and changes in net assets and are weighted 10 percent and 20 percent, respectively.

Institutions may have differing values across the four component ratios but still have equivalent overall financial health as indicated by similar composite scores. This approach allows easy comparisons of relative financial health across different institutions. Looking at the composite scores, *Strategic Financial Analysis for Higher Education* suggests a composite value of 1.0 is equivalent to very little financial health, in the for-profit world it could perhaps be viewed as a “going-concern” threshold value, while a composite value of 3.0 is considered to signify relatively strong financial health, an organization with moderate capacity to deal with adversity or invest in innovation and opportunity. CFI scores greater than 3.0 represent increasingly stronger financial health.

### *Is CFI new to the System?*

The System started using CFI as an internal measure of financial health about five years ago. Colleges and universities incorporate CFI and other measures as deemed pertinent, including non-financial information, to prepare an annual “Financial Trends and Highlights” presentation. Audited colleges and universities present this annual assessment as part of the external audit exit meeting. Colleges not subject to external audit present the same assessment at one of several meetings where college leadership for 3 – 5 colleges plus system office finance personnel meet using a round-table discussion format. These have proven to be good learning and sharing opportunities.

November’s Audit Committee meeting included a high-level discussion of CFI, and the System’s Annual Financial Report for the Years Ended June 30, 2009 and 2008 included much of the CFI information that follows within the Management Discussion and Analysis.

Before looking at comparative CFI data and individual financial ratio values, the table below uses the System’s fiscal year 2009 ratios and presents the CFI calculation, which first converts ratio values to strength factor values [(1)/(2)], applying the weighting factors to determine weighted strength factor values [(3)\*(4)] and finally summing weighted strength factors to arrive at the composite value of CFI. It should be noted that the table also shows System CFI including the nine foundations presented separately in the System’s annual financial report.

CFI Calculation Matrix					
Calculation step	Primary Reserve	Return on Net Assets	Viability	Net Operating Revenue <sup>1</sup>	CFI
(1) <b>FY2009 System Ratio values</b>	<b>0.208</b>	<b>0.074</b>	<b>0.788</b>	<b>(0.005)</b>	n/a
(2) Base Strength factor (set) <sup>2</sup>	0.133	0.02	0.417	0.007	n/a
(3) = [(1) ÷ (2)] Computed Strength factor <sup>3</sup>	<b>1.56</b>	<b>3.70</b>	<b>1.89</b>	<b>(0.77)</b>	n/a
(4) Weighting factor (set)	0.35	0.20	0.35	0.10	1.00
Weighted value—					
System	<b>0.55</b>	<b>0.74</b>	<b>0.66</b>	<b>(0.08)</b>	<b>1.87</b>
System with 9 Foundations	<b>0.55</b>	<b>0.55</b>	<b>0.62</b>	<b>(0.10)</b>	<b>1.62</b>
<sup>1</sup> Also called Operating Margin ratio					
<sup>2</sup> A standard, fixed base value denoting a border-line or minimal level of financial health (“going concern”).					
<sup>3</sup> Following HLC protocol, these values are capped at -1.0 for and + 10.0 for computed strength factor values below - 1.0 or above +10.0.					

***How does the System’s financial health compare to other public institutions?***

The FY 2008 values in the Composite Financial Index (CFI) Comparisons table below are computed from ratio values contained in *Moody’s Fiscal Year 2008 Public College and University Medians* report and as such represent median values for 191 public colleges and universities rated (in whole or in part) within Moody’s public college and university portfolio. Fiscal year 2009 public college and university financial data is not available as yet. Rated components range from large state higher education systems to small public colleges and universities. Ratings may also be for a segment of a system or institution such as the System’s Revenue Fund, which is falls within the “Aa3” rating below.

The letter-based credit rating designations in the CFI comparison table below are defined and used by Moody’s Investors Services. All ratings denote creditworthiness relative to other US municipal or tax-exempt issuers or issues. The relative credit worthiness is: Aaa = strongest, Aa = very strong, A = above average and Baa = average.

The System’s and Revenue Fund’s weighted components’ and composite values are compared below with those of the various rating categories extracted from the Moody’s median report. Required calculations have been made by the System using four specific Moody’s median financial ratio values for each rating category and for the population as a whole. This information should only be used as an approximate indicator of the System’s financial health relative to the financial health of other public colleges and universities. The System’s individual colleges and universities show a similar range of composite values.

Composite Financial Index (CFI) Comparisons										
Financial Performance Measure	FY09 System* & Revenue Fund		Moody's 2008 Public College/University Medians - Converted to Weighted Values and Composite Statutory Income (CFI)							
	System *	Revenue Fund	All	Aaa/Aa1	Aa2	Aa3	A1	A2	A3	Baa
Primary Reserve	0.55	2.24	1.18	2.61	1.42	1.26	1.39	1.08	0.82	0.53
Viability	0.62	0.31	0.84	1.85	1.43	1.01	0.76	0.50	0.34	0.25
Net Operating Revenue	(0.10)	1.00	0.26	0.60	0.43	0.41	0.20	0.10	0.23	(0.10)
Return on Net Assets	0.55	0.62	0.40	0.32	0.32	0.41	0.40	0.42	0.54	(0.20)
CFI	1.62	4.17	2.68	5.37	3.60	3.09	2.75	2.10	1.92	0.48
- The shaded cells link System values to the closest value(s) within a credit rating category										
* Consistent with Moody's underlying ratios the System's individual and composite (CFI) values include component units; <b>component units reduced CFI from 1.87 to 1.62 due primarily to the foundations' collective realized and unrealized losses on investments.</b>										

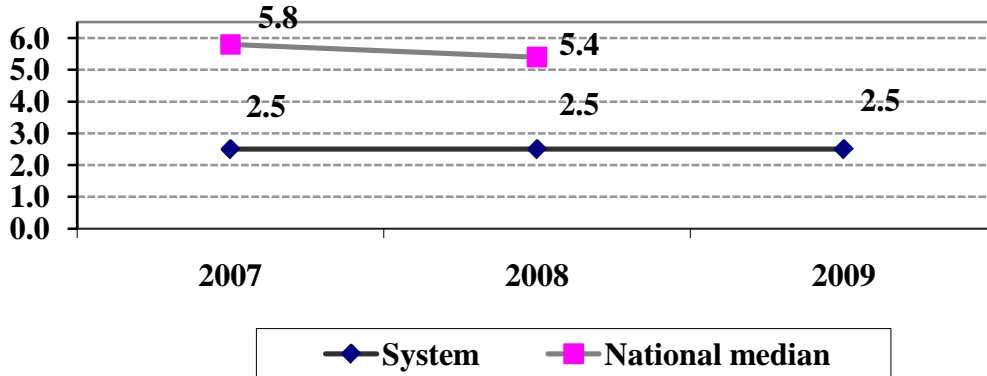
**Summary ratios for FY2009, FY2008 and FY2007**

The system-wide financial ratios and other measures presented below are generally consistent with prior years' presentations. The focus this year is on the four financial ratios used in computing CFI. The "National Median" data is taken from *Moody's Fiscal Year 2008 Public College and University Medians* report. All System ratios are computed using financial data taken from the accrual financial statements. *Note: Higher values are deemed better for all ratios presented.* The *Supplement to the Annual Financial Report* may be examined to view individual college and university financial statements (<http://www.finance.mnscu.edu/accounting/financialstatements/yearendstatements/index.html>).

Moody's national data population includes a wide range of rated public institutions, including Research I institutions, but does not include two-year colleges (except for those included in a system) and so is not strictly comparable in all respects to the Minnesota State Colleges & Universities system. In addition, the Moody's data include component units (e.g., foundations) while the System data does not include foundations.

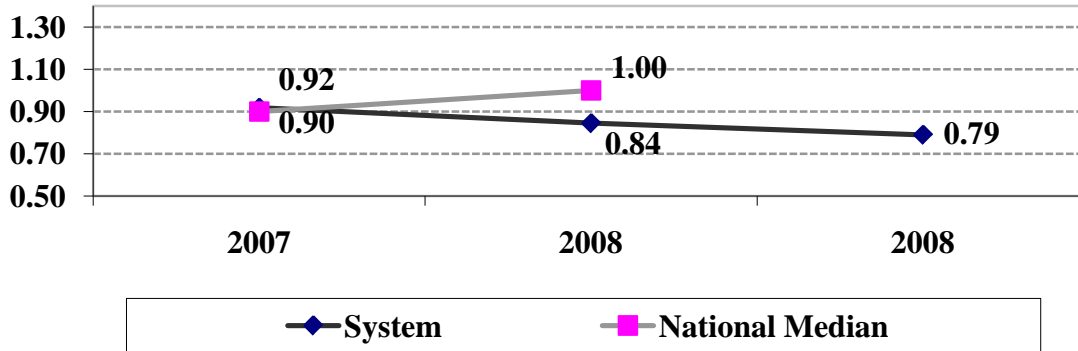


### Primary Reserve (# of months)



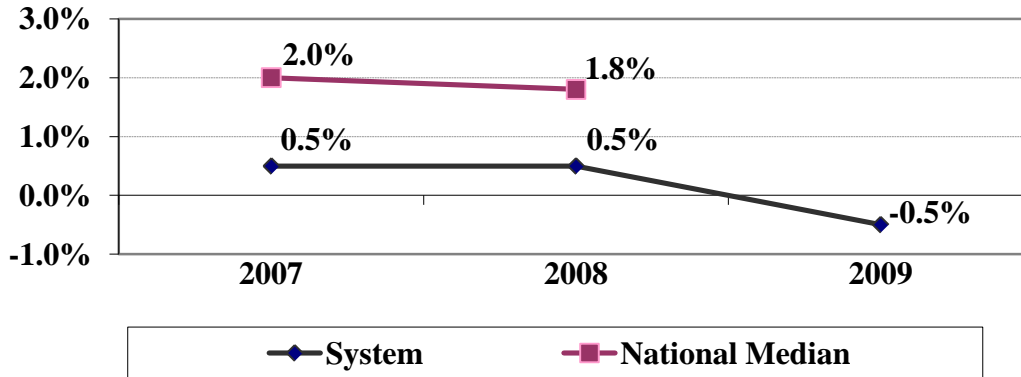
The number of months of primary reserve values shown above measure capacity to fund operating expenses without generating new assets such as could happen due to a significant business interruption event. This is an accrual measure somewhat similar in concept to the Board’s “budget reserve” ratio. An increasing primary reserve measure indicates that expendable (restricted and unrestricted) net assets have increased from one year to the next at a greater pace than the growth in operating expenses.

### Viability Ratio



The viability ratio above is a debt management measure that demonstrates the extent to which outstanding debt (current and noncurrent portions of bond debt, capital lease debt and notes payable) as of June 30, 2009 could have been settled through use of expendable net assets (the same numerator as used to compute the primary reserve ratio above). A value of 1.0 or greater indicates the ability to settle all debt. Decreases in the ratio for the years presented below indicate that the System has not been able to increase expendable net assets at a rate equal to or greater than the approximate 33 percent increase in debt from June 30, 2007 to June 30, 2009.

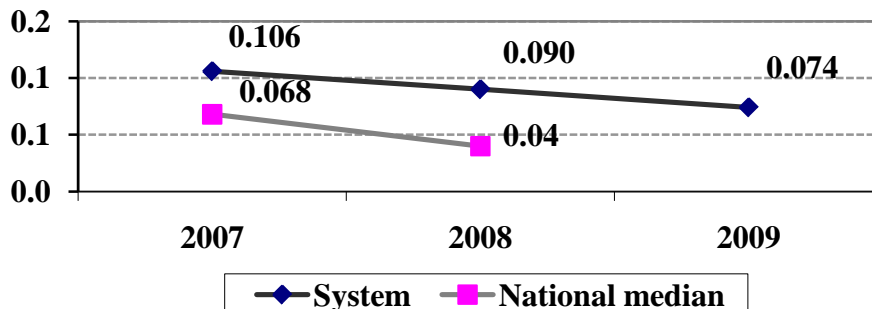
### Net Operating Revenue Ratio



The net operating revenues ratio above (sometimes referred to as the operating margin ratio) is a measure of the surplus or deficit generated by on-going operations and as such impacts the other three ratios through increasing or decreasing net assets. Net operating revenue totaled (\$9.3) million, \$8.4 million and \$7.1 million, respectively, in fiscal years 2009, 2008 and 2007. This is the “Income (Loss) Before Other Revenues, Expenses, Gains, or Losses” line found on the statements of revenues, expenses, and changes in net assets.

Comparing the fiscal year 2008 median value of 1.8 percent and the fiscal year 2009 System value of -0.5 percent in the graph above, the median value represents \$18,000 income per \$1,000,000 of operating revenue while the System value represents \$5,000 (loss) per \$1,000,000 of operating revenue. To equal the 2008 Moody’s national median of 1.8%, the system would have required positive net operating revenue of \$31.2 million for fiscal year 2009.

### Return on Net Assets



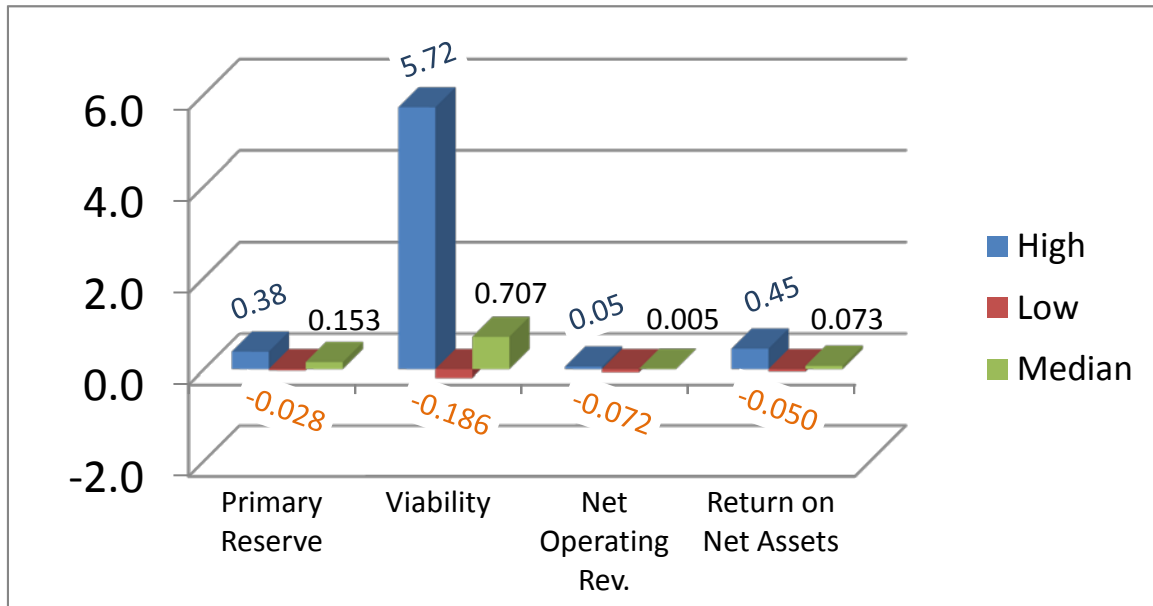
The return on net assets ratio above is in many respects a measure of financial stewardship. Given the assets available at the start of the fiscal year, has financial position improved or deteriorated as measured by the change in net assets line on the statements of revenues, expenses, and changes in net assets?

The System’s return on net assets ratio is positively impacted by the state’s financing of a significant portion of the System’s buildings, building improvements, repairs and renovations, which has generated capital appropriation revenue of \$106.7 million, \$102.1 million, and \$117.2 million in fiscal years 2009, 2008, and 2007, respectively. Capital appropriation is the reason for the significant difference between the System’s net operating revenue ratio below and the return on net assets ratio. Without capital appropriation revenue, the System would need to generate equivalent net operating revenue through higher tuition and state operating appropriation or seek authority to issue equivalent debt.

**Ratio Variability across Colleges and Universities**

The graph below shows the broad ranges of individual CFI financial ratio values across all the colleges and universities. The primary reserve data is presented as a ratio; the equivalent number of months is computed by multiplying the ratio value times 12 (e.g., 0.38 x 12 = 4.6 months). The viability ratio value of 5.72 relates to a college with extremely low debt and as such is an outlier as the next highest value is 2.94.

**Variability in Fiscal Year 2009 Colleges’ and Universities’ Financial Ratios**

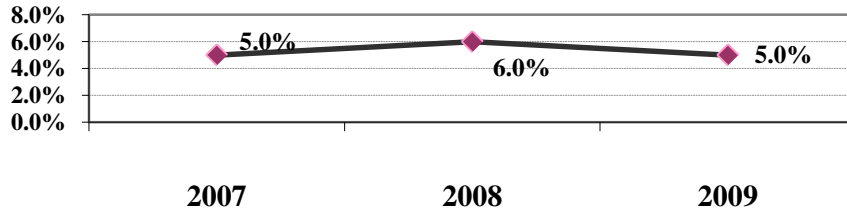


**Other Financial Measures for FY 2009, FY2008 and FY2007**

The Board required reserve ratio below compares general fund cash-basis operating revenues to that portion of the general fund’s end-of-year cash balance that has been designated as a special reserve amount; this is the total for all colleges & universities. The figure of 5 percent for fiscal year 2009 represents \$74.5 million. The primary

reserve measure discussed further above is somewhat similar in concept but is an all funds accrual-based measure computing the number of months of operating expenses covered by expendable net assets.

**Board Required Reserve--Total Colleges & Universities**



As shown below, 15 of the system’s 32 colleges and universities continue to generate negative net operating revenues using a generally accepted accounting principles measurement; this compares to 19 colleges and universities in fiscal year 2008. However it should also be noted that the consolidated net operating revenue declined from a positive \$8.4 million in fiscal year 2008 to a negative \$9.3 million in fiscal year 2009. Of the 15 colleges and universities with negative net operating revenue in fiscal year 2009, 10 had negative net operating revenue in all three fiscal years shown above. Ongoing operating deficits negatively impact the ability of these institutions to maintain normal operations under adverse economic circumstances, such as the current recession, or implement new strategic initiatives. Negative unrestricted net assets generally indicate a college or university has experienced ongoing operating deficits. A Board reserve at less than 3 percent can also be an indicator of poor financial condition.

	<u>FY2009</u>		<u>FY2008</u>		<u>FY2007</u>	
	<u>#</u>	<u>%</u>	<u>#</u>	<u>%</u>	<u>#</u>	<u>%</u>
<b>Net operating revenue loss*</b>	15	47%	19	59%	18	56%
<b>Negative unrestricted net assets</b>	1	3%	1	3%	1	3%
<b>Board reserves below 3%</b>	2	6%	2	6%	2	6%

\* As shown in financial statements on line titled “Income (loss) before other revenues, expenses, gains, or losses.” The Northeast Higher Education District is considered one college.

**CONCLUSION**

The system’s financial condition improved during FY2009 as measured by the increase in net assets; this reflects the strong financial management exercised by the system’s leadership team and continued strong investment in capital assets. The current recession raises significant concerns regarding the ability of state government to maintain future years’ funding in the form of appropriation and grant revenue.

- Fiscal year 2009 state appropriation initially exceeded fiscal year 2008 by \$17 million; however, the state's projected fiscal year 2009 deficit resulted in a \$20 million downward appropriation adjustment.
- Fiscal year 2010 appropriation revenue of approximately \$678 million, including one-time federal stimulus funding of approximately \$64 million, is expected to exceed fiscal year 2009 revenue by about \$15 million.
- Fiscal year 2011 appropriation revenue, including a \$50 million appropriation unallotment, is expected to fall approximately \$62 million from fiscal year 2010 to approximately \$616 million.
- The early December 2009 Minnesota Management and Budget projection includes a \$1.2 billion deficit for the FY2010-2011 biennium and \$5.4 billion deficit for the FY2012-2013 biennium.

Increases in long-term debt, both general obligation and revenue bond debt, are reflected in a declining viability ratio, and this may continue in future years subject to increases in capital bonding support and Revenue Bond sales. Increases in debt service coupled with declining appropriation revenue may place an additional financial burden on some institutions in future years. Similarly, continued negative net operating revenue at multiple colleges and universities will cause financial stress.

*Date Presented to the Board: January 20, 2010*