

4.01.00.02 Institutional Financial Performance Review



4.01.00.02 Institutional Financial Performance Review

Policy/Guideline Area

Business and Finance Policies

Applicable Divisions

TCATs, Community Colleges, System Office

Purpose

It is the policy of the Board that institutions have a sound financial base and demonstrate financial stability sufficient to support the mission of the institution over the long term. Although missions may vary among institutions, a sound financial base and a pattern of financial stability provide the foundation for accomplishing an institution's mission, regardless of changing economic conditions. Financial and physical resources should be managed in a manner that permits the institution to fulfill its mission long term.

Policy/Guideline

- I. Responsibility
 - A. The chief executive officer of each institution is responsible for administering and managing the institution's financial affairs in such a manner as to ensure the institution's current and future financial health. This policy establishes the tools used to assess the financial health of an institution, the reporting process, and actions to be taken if an institution shows signs of financial weakness.
- II. 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 an institution’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 institution’s strategic direction;
 - 3. Do operating results indicate the institution is living within its available resources; and
 - 4. Is debt managed strategically to advance its mission.
- C. To address these four questions, data from an institution’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.
- D. Additionally, trends in adjusted unrestricted net position will be monitored to determine the overall financial health of the institutions. Adjusted net position is the unrestricted net position adjusted to eliminate the impact of deferred inflows related to pensions; deferred inflows related to OPEB; noncurrent liabilities for compensated absences; net pension liability; net OPEB obligation; current liabilities for compensated absences; deferred outflows related to pensions; and deferred outflows related to OPEB.

III. Calculation of Core Ratios and CFI

- A. All calculations include the financial results of the institution’s component unit (i.e. related foundation(s), noted as “CU”) to present a comprehensive picture of the institution’s overall financial condition. The data source for calculation of

each ratio is the institution'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 Position

- a. Description: The return on net position 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 institution?" 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: **Change in Net Position + CU Change in Net Position / Total Net Position (beginning of year) + CU Total Net Position (beginning of year)**

2. Expected Performance Standard: The return on net position 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 position ratio of 6 percent is desirable.
3. Watch Level: Consistently below the rate of inflation. Anything below the rate of inflation indicates a reduction of the institution's asset base in real dollars, thereby eroding the purchasing power of institutional resources for future generations.
- a. Net Operating Revenues Ratio

- (1) Description: The net operating revenues ratio indicates an operating surplus or deficit in the given fiscal year. A positive ratio indicates that the institution 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 institution is living within available resources?” Depreciation expense is included to reflect the use of physical assets in measuring operating performance.
 - (a) Calculation: **Operating Income (Loss) + Non-operating Revenues (Expenses) + CU Change in Unrestricted Net Position / Operating Revenues + Non-operating Revenues + CU Total Unrestricted Revenue**
- (2) 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.
- (3) Watch Level: Consistently below zero. A deficit in a single year does not necessarily indicate a problem, but unexplained deficits over several years could be a cause for concern and suggest that the institution’s mission cannot be sustained and institutional finances should be restructured.

b. Primary Reserve Ratio.

- (1) Description: The primary reserve ratio measures financial strength and flexibility by comparing expendable net position to total expenses. This measure answers the question, “How long can the institution survive without additional net position generated by operating revenue?”

- (a) Calculation: **Expendable Net Position + CU Expendable Net Position / Total Expenses + CU Total Expenses**
- (2) Expected Performance Standard: A ratio of 0.40 (representing about 5 months of expenses) or higher. At this level an institution has the flexibility to manage minor financial disruptions and other unforeseen events with less need to immediately disrupt ongoing activities. At this level, an institution can be expected to carry on a reasonable level of facilities maintenance activities.
- (3) Watch Level: A ratio of 0.133 (represents less than 1.5 months of expenses in ready assets) or less. Institutions at these levels have less operating flexibility to meet unexpected events, generally lack sufficient resources to pursue strategic initiatives, and may struggle to invest in plant maintenance.
- c. Viability Ratio
- (1) Description: The viability ratio measures the financial health of the institution by comparing total expendable net position to total current and non-current plant debt. 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 institution pay off with existing resources" and "Is debt managed strategically to advance the institution's mission". For institutions with no debt or nominal debt, this ratio is ignored in the calculation of the CFI score. A ratio of 1.0 indicates an institution has expendable resources sufficient to satisfy all outstanding plant related debt.

(a) Calculation: **Expendable Net Position + CU Expendable Net Position / Plant Related Debt + CU Plant Related Debt**

- (2) Expected Performance Standard: A ratio of 1.25 or higher (the higher the ratio, the stronger the credit-worthiness of the institution). At these levels, an institution has increased flexibility to address unexpended events.
- (3) Watch Level: A ratio of 0.41 or less. Similar to the primary reserve ratio Watch level, institutions at this level have decreased flexibility to respond to unforeseen events, essentially a reduced “margin of error” in the financial management of the institution. Dropping below a ratio of 0.41 may identify the institution as a credit risk.

IV. 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 institution. By blending these four core financial ratios into one metric, a more balanced view of the institution’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 institutions are 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. Institutions with More than Nominal Outstanding Debt:

Core Ratio Value		Threshold Value		Strength Value		Weight		Score
Return on Net Position	/	0.020	=	0.00	x	20%	=	0.00
Net Operating Revenues	/	0.013	=	0.00	x	10%	=	0.00
Primary Reserve	/	0.133	=	0.00	x	35%	=	0.00
Viability	/	0.417	=	0.00	x	35%	=	0.00
Composite Financial Index Score							=	0.00

b. Institutions with No or Nominal Outstanding Debt:

Core Ratio Value		Threshold Value		Strength Value		Weight		Score
Return on Net Position	/	0.020	=	0.00	x	30%	=	0.00
Net Operating Revenues	/	0.013	=	0.00	x	15%	=	0.00
Primary Reserve	/	0.133	=	0.00	x	55%	=	0.00
Viability	/	0.417	=	0.00	x	0%	=	0.00
Composite Financial Index Score							=	0.00

- B. Expected Performance Standard: A score of at least 3.0. Strategic Financial Analysis for Higher Education indicates that at this level an institution is relatively financially healthy in that sufficient liquid resources exist to meeting unforeseen circumstances, net operating revenues are adequate, expendable net position exceed the level of debt, and the return on net position 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 institution's long-term ability to carry out existing programs and survive.

V. 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 an institution may be better ascertained. This is true for the various ratios that are used to compute the CFI, the CFI itself, as well as overall the trends in unrestricted net position.

VI. Process for Reporting

- A. After completion of the financial statements review by board staff, the ratios, CFI score and trends in adjusted unrestricted net position will be computed by board staff and will be provided to the college presidents and business officers for their review. Furthermore, the results will be reviewed with the chancellor and Board. Using a holistic approach to evaluate the overall financial health of an institution, the Vice Chancellor for Business and Finance and staff will review the ratios, CFI scores, and adjusted unrestricted net position for the current period and trends over time. Often there are underlying reasons why a particular ratio, the CFI, or the adjusted unrestricted net position may not be at the desired level, but which do not pose a significant risk to the institution. In those cases, the Vice Chancellor should document the reason and no further explanations would be needed. However, if the Vice Chancellor, using their

professional judgement, has concerns over a particular ratio, the CFI, the adjusted unrestricted net positions, or trends with any of the aforementioned, the chief business officer or TCAT president shall provide a narrative that addresses the concerns. The submission shall also address what action the institution plans to take to improve the ratio, the CFI, and/or the adjusted unrestricted net position in subsequent years.

- B. The System Office shall review the narrative submitted by the institution. If deemed necessary by the Vice Chancellor, the System Office will review with the community college chief business officer and/or president or the TCAT president the adequacy of the institution's plan to address the issue. Concerns regarding the adequacy of such plans, if any, shall be communicated to the Chancellor and the institution's president. Any concerns of the Vice Chancellor or Chancellor will be brought to the attention of the Board.
- C. On an annual basis, the Board shall be advised on the aggregate overall financial performance of the System and its institutions, in summary by sector. The System Office staff shall report to the Board any institution whose performance meets the Composite Financial Index Watch Level criteria specified in this policy.

Sources

Authority

T.C.A. § 49-8-203

History

NEW Policy approved at Board Meeting, September 26, 2014; Revision approved at Board Meeting, September 21, 2017; Revision approved at Board Meeting, June 17, 2022.

Related Policies

[4.01.00.01 Budget Principles and Control](#)