College for all Texans

Texas Higher Education Coordinating Board

Financial Condition Analysis Of Texas Public Community College Districts

2013

Planning and Accountability

Texas Higher Education Coordinating Board

Advisory Workgroup

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Mission of the Coordinating Board

The Texas Higher Education Coordinating Board's mission is to work with the Legislature, Governor, governing boards, higher education institutions, and other entities to help Texas meet the goals of the state's higher education plan, *Closing the Gaps by 2015*, and thereby provide the people of Texas the widest access to higher education of the highest quality in the most efficient manner.

Philosophy of the Coordinating Board

The Texas Higher Education Coordinating Board will promote access to quality higher education across the state with the conviction that access without quality is mediocrity and that quality without access is unacceptable. The Board will be open, ethical, responsive, and committed to public service. The Board will approach its work with a sense of purpose and responsibility to the people of Texas and is committed to the best use of public monies. The Coordinating Board will engage in actions that add value to Texas and to higher education. The agency will avoid efforts that do not add value or that are duplicated by other entities.

Executive Summary

An annual report about the financial condition of the state's community colleges is required as referenced in the General Appropriations Act, House Bill 1 (HB 1), 82nd Texas Legislature, Section 14 (page III-198). The rider states:

> *"Each community college shall provide to the Texas Higher Education Coordinating Board financial data related to the operation of each community college using the specific content and format prescribed by the Coordinating Board. Each community college shall provide the report no later than January 1st of each year.*
>
> *The Coordinating Board shall provide an annual report due on May 1 to the Legislative Budget Board and Governor's Office about the financial condition of the state's community college districts."*

The objective of this report and the accompanying excel workbook is to provide an assessment of the overall financial health of public community colleges and to identify institutions in which the potential for financial stress exists. The analysis included is intended to be a broad financial evaluation. Other key performance indicators must be taken into account to gain a more robust and complete understanding of institutional strength. This analysis is not intended for peer group comparisons or for benchmarking purposes.

The overall financial health of an institution can be measured on two dimensions of inquiry. First, is the institution financially capable of successfully carrying out its current programs? Second, is the institution able to carry out its intended programs into the future?

Outstanding long-term debt obligations have increased $1.19 billion since Fiscal Year 2008. Most of the increase has been the general obligation bonds issued by districts. For Fiscal Year 2012 the combined non-current obligations for the public community colleges was $4.275 billion. Overall the public community colleges are managing the growth they have experienced. This is reflected in the increase in net assets of $353 million in Fiscal Year 2012 over Fiscal Year 2011. Net assets have increased $1.186 billion since Fiscal Year 2008 to $5.326 billion in Fiscal Year 2012. Expendable net assets for Fiscal Year 2012 are $1.873 billion.

Ratios referenced in this report are commonly used by external entities to measure the health of higher education institutions. A composite financial index (CFI) was calculated to provide one metric to more efficiently analyze the financial health of all the districts. Other ratios used in this analysis include an equity ratio, and leverage ratio.

The institutions were given an opportunity to provide feedback. A summary of their comments is included in Appendix B.

Overview

There are 50 public community college districts in Texas, the oldest dating back to 1869. They are locally controlled governmental entities established via an election process. State statute specifies that new districts created must have 15,000 secondary students and a minimum assessed property valuation of $2.5 billion. Eleven of the existing districts do not meet that rule.

To a significant degree, local control enables the districts to determine their own financial destiny. State law and Coordinating Board rules impose some limitations, but local autonomy and demographics account for much of the variation in resource allocation and revenue collection.[1]

The majority of the revenue the districts receive is from four sources, including state formula funding, local property tax revenue, tuition and fee revenue, and other income which is largely federal funds. Although some districts do have endowments, they are more commonly found in universities, and revenue from them is often used for tuition assistance as opposed to operations.

Financial Analysis in Higher Education[2]

The concept of using selected indicators, such as ratios, during the course of financial analysis is nothing new in higher education and dates back to at least 1980. Financial analysis can measure success against institutional objectives and provide useful information upon which sound planning can be based.

The overall financial health of an institution can be assessed via two dimensions of inquiry. First, is the institution financially capable of successfully carrying out its current programs? Second, is the institution able to carry out its intended programs well into the future?

Along those two dimensions, four key financial questions need to be asked:

- Are resources sufficient and flexible enough to support the mission?
- Are resources, including debt, managed strategically to advance the mission?
- Does asset performance and management support the strategic direction?
- Do operating results indicate the institution is living within available resources?

A widely accepted metric called the Composite Financial Index (CFI) is often used to address these four key questions. The index was developed over time by a consortium of consulting companies led by KPMG and introduced in 1999. The index itself, or similar approaches, is employed by many institutions, including the U.S. Department of Education, the State of Ohio Board of Regents, credit rating agencies, and countless other institutions of higher education.

The CFI blends four core financial ratios into one metric, providing a more balanced view of the institution's finances 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.

The Coordinating Board has been calculating the CFI and sharing related data with the community college districts since 2007. The composite financial index includes the following core ratios:

<u>Primary Reserve Ratio</u> – measures financial strength and flexibility by comparing expendable net assets to total expenses. This measure answers the question, "How long can the institution survive without additional net assets generated by operating revenue?" The 2012 statewide ratio for the public community colleges is .40 which is an increase from .35 in 2011. A ratio of 0.14 or greater is the standard used in this report. The standard was met by 48 of the 50 districts.

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[1] Texas Research League, *Bench Marks for Community and Junior Colleges in Texas*, August 1993.
[2] For more information see the book *Strategic Financial Analysis for Higher Education*, Sixth Edition, KPMG, Prager, Sealy and Co, Bearing Point.

Viability Ratio – measures the financial health of the institution by comparing total expendable net assets to certain non-current liabilities. The 2012 statewide ratio for the public community colleges is 1.03 which is an increase from 1.00 in 2011. A ratio of 0.42 or greater is the standard used in this report. The standard was met by 44 of the 50 districts.

Return on Net Assets – measures total economic return during the fiscal year. The 2012 statewide ratio for the public community colleges is 7.10% which is an increase from 5.15% in 2011. A positive return is the standard used in this report. The standard was met by 47 of the 50 districts.

Operating Margin – indicates an operating surplus or deficit in the given fiscal year. The 2012 statewide margin for the public community colleges is 6.17% which is an increase from 4.85% in 2011. A positive margin is the standard used in this report. The standard was met by 46 of the 50 districts.

Composite Financial Index - CFI numbers generally range from 0.0 to 10.0, although it is possible to have a number higher than 10.0. It is also possible to have a CFI below zero. The 2012 combined CFI for the public community colleges is 3.67 which is an increase from 2.96 in 2011. An index number of 2.0 or greater is the standard used in this report. The standard was met by 45 of the 50 districts.

Appendix A provides more detail as to how the core ratios are calculated and how the CFI is determined. In addition to the CFI, a more robust understanding is obtained via additional indicators that can affect an institution's finances. They are described below.

Equity Ratio **-** An equity ratio is a comparison of net assets to total assets and is used when institutions have no outstanding indebtedness. The 2012 statewide ratio for the public community colleges is 49.5% which is an increase from 47.6% in 2011. A ratio of 20% or greater is the standard used in this report. The standard was met by 49 of the 50 districts.

Leverage Ratio - The leverage ratio measures the amount of debt in relation to net assets and provides an indication of the amount of debt service the institution must absorb into the future relative to existing resources. General obligation bonds are excluded for this calculation. The 2012 statewide ratio for the public community colleges is .33 which is an increase from .32 in 2011. A ratio of less than 2.0 is the standard used in this report. The standard was met by 48 of the 50 districts.

Appendix C has the indicators for the 50 districts for fiscal year 2012. There is an Excel workbook available with all financial data used for the indicators and includes data for fiscal years 2003 to 2012.

The financial data used in this analysis came from CARAT (Community College Annual Reporting and Analysis Tool). CARAT is available online at: https://www1.thecb.state.tx.us/apps/CARAT/. Data are reported by the institutions and came from published annual financial reports.

Financial Condition

Forty-six of the 50 public community college districts have little or no indication of financial stress which is an improvement of eight institutions since Fiscal Year 2011. Thirty-nine of those 46 meet the threshold for all indicators. They are adequately capitalized, adding positive net asset balances, and are properly positioned for future success. The remaining seven do not meet the threshold for two or fewer indicators.

There are four institutions that do not meet the threshold for three or more of the indicators. The number of institutions in this category has decreased by eight since fiscal year 2010. A discussion of these institutions is included below.

Coastal Bend College, did not meet five of the indicator thresholds. The CFI, return on net assets, and operating margin were negative. Net assets fell $3.6 million which lowered the primary reserve to less than 10%. In the previous four years the college has had a positive operating margin and return on net assets. The college has met the 2.0 threshold on the CFI in the previous two years.

Austin Community College (ACC) did not meet four of the indicator thresholds. The ratios that include non-current debt; equity, leverage, and viability ratios are all below the standard used for this report. Since the CFI includes viability ratio, that lowered the index below the 2.0 threshold. The college has not utilized general obligation bonds in the recent expansions, which have been excluded from the non-current debt ratios used in this report. The college met the threshold for operating margin, return on net assets and primary reserve. On April 8, 2013, the rating agency, Moody's, gave ACC a rating of Aa1 on a bond issue and indicated the outlook for the college was stable.

Frank Phillips College did not meet three of the indicator thresholds. The CFI, return on net assets, and operating margin were negative. In the previous 2 years the college has had a negative operating margin and has not met the 2.0 threshold on the CFI.

Victoria College did not meet three of the indicator thresholds. The CFI, return on net assets, and operating margin were negative. In the previous five years the college has had a positive operating margin; and return on net assets has been positive in four of the past five years. The CFI has been above the 2.0 threshold in four of the five previous years.

Conclusion

There has been significant improvements in the financial condition of the community colleges in fiscal year 2012 compared to fiscal years 2010 and 2011.

	FY 2012	**FY 2011**	**FY 2010**
Met all indicators	39	33	22
Not meeting one indicator	6	8	10
Not meeting two indicators	1	4	6
Not meeting three indicators	2	2	7
Not meeting four indicators	1	1	5
Not meeting five indicators	1	2	0
Statewide CFI	3.67	2.96	2.74

Appendix A – Definitions

Composite Financial Index (CFI) – measures the overall health of an institution by combining four ratios into one metric. The four core ratios include return on net assets, operating margin, primary reserve, and viability ratio. The CFI is computed using a four-step methodology:

1. Computing the values of the core ratios.
2. Calculating strength factors by dividing the core ratios by threshold values.
3. Multiplying the factors by specific weights.
4. Totaling the resulting scores to obtain the composite financial index.

Core Ratio		**Value**		**Strength Factor**		**Weight**		**Score**
Return on Net Assets	/	0.02	=	Factor	X	20%	=	Score
Operating Margin	/	0.007	=	Factor	X	10%	=	Score
Primary Reserve	/	0.133	=	Factor	X	35%	=	Score
Viability Ratio	/	0.417	=	Factor	X	35%	=	Score
				Composite Financial Index			**=**	**Total Score**

The threshold for the CFI was established by considering the original work conducted by KPMG in creating the index and industry practice.

Return on Net Assets – 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 question, "Are they better off financially than they were a year ago?"

<u>Change in net assets</u>
Total net assets (beginning of year)

Operating Margin – indicates an operating surplus or deficit in the given fiscal year. This ratio is similar to a profit margin and answers the question, "Did they balance operating expenses with available revenue?" Depreciation expense is included to reflect the use of physical assets in measuring operating performance.

<u>Total income – total operating expense</u>
Total income*

*Includes all operating revenue plus formula funding, property tax, and Title IV federal revenue.

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 institution survive without additional net assets generated by operating revenue?"

<u>Total expendable net assets + unrestricted net assets</u>
Operating expenses + interest expense on debt

Interest Expense in debt includes all debt, both tax and other revenue supported.

Viability Ratio – measures the financial health of the institution by comparing total expendable net assets to total 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 and answers the question, "How much of their debt can the institution pay off with existing resources?"

<u>Total expendable net assets + unrestricted net assets</u>
Non-current liabilities excluding general obligation (GO) debt

Equity ratio – measures capital resources available and the college's ability to borrow. This ratio was introduced by the U.S. Department of Education (DOE) as part of its financial responsibility ratios to be used instead of the viability ratio for those institutions that do not have long-term debt. The DOE uses financial ratios in part to provide oversight to institutions participating in programs authorized under Title IV of the Higher Education Act.

<u>Net assets</u>
Total assets

Leverage ratio – measures the amount of debt in relation to net assets and provides an indication of the amount of interest and principle the institution must absorb in the future. This ratio is similar to the debt to equity ratio used in the private sector. The leverage ratio differs from the viability ratio in that investment in physical plant assets is included as part of the numerator.

<u>Long term debt*</u>
Total net assets

*Long-term debt includes bonds payable excluding GO bonds, and long-term liabilities.

Appendix B: Feedback Received from the Institutions

Van D. Miller, M.B.A., Ed.D.; V.P. Administrative Services/C.F.O.; Temple College

I think this is an outstanding report. I have only one reservation: If one truly follows the CFI guidelines as created by KPMG, a maximum strength factor for any given ratio should be limited to 10. As a result, the maximum CFI that anyone should receive is 10. Because no limits are being placed on these individual categories, we find the statewide average for CFIs at all CCs is in excess of 10! 10 is designed to be the perfect score. Allowing these individual ratios to go way above 10 skews the results when everything is put together. I really wish the Board would consider adhering to the original guidelines and placing these limits on individual ratios to make the final numbers more meaningful. (The direct quote from *Strategic Financial Analysis for Higher Education* states that, "extending strength factors beyond 10 will create a higher CFI and may unduly mask a weakness in another ratio.") Thanks for the good work!

There is agreement with this recommendation and the worksheet has been revised to limit the CFI to a maximum of 10.

Beatriz T. Espinoza, Ph.D., President, Coastal Bend College

Fiscal Year 2012 was a transitional period for Coastal Bend College (CBC). In the span of one fiscal year the college had three presidents along with changes and additions in upper administration. During this period, unplanned expenditure increases were incurred. On June 1, 2012, CBC Board of Trustees hired a permanent President. The new administration has addressed this matter. New processes are in place that will ensure that this does not occur in the future. Cost-saving measures were pursued in Fiscal Year 2013 in order to increase operating efficiency of the college. Board of Trustee members, administrative officers, faculty, and staff are all actively involved in the budgeting process for Fiscal Year 2014, allowing for a more complete and accurate working budget for the college. Coastal Bend College is working diligently to provide the best value and quality in service to the students of South Texas and beyond while working to be good stewards of student and taxpayer dollars.

Appendix C

Composite Financial Index, Core Financial and Other Ratios

District	Composite Financial Index	Return on Net Assets	Operating Margin	Primary Reserve	Viability Ratio	Equity Ratio	Leverage Ratio
Alamo	2.28	4.34%	4.54%	0.29	0.52	29.0%	0.78
Alvin	**1.91**	5.99%	0.91%	0.18	0.83	49.3%	0.39
Amarillo	5.13	1.33%	2.27%	0.45	6.50	53.4%	0.04
Angelina	5.55	6.87%	2.76%	0.37	12.50	57.1%	0.02
Austin	**1.34**	1.93%	4.38%	0.15	**0.14**	**16.5%**	**3.20**
Blinn	2.27	5.63%	6.08%	0.18	0.43	54.6%	0.43
Brazosport	2.29	6.31%	3.19%	0.16	0.92	30.7%	0.19
Central Texas	7.58	8.69%	10.72%	0.84	93.91	85.4%	-
Cisco	2.52	5.15%	5.89%	0.27	0.55	47.2%	0.71
Clarendon	3.39	4.68%	10.01%	0.46	0.86	72.8%	0.08
Coastal Bend	**(0.69)**	**-25.69%**	**-6.36%**	**0.07**	**0.39**	42.4%	0.27
College Of The Mainland	5.23	4.52%	3.83%	0.28	5.09	71.1%	0.01
Collin	8.64	6.40%	13.87%	1.51	66.86	86.3%	0.01
Dallas	3.73	2.85%	6.82%	0.42	1.62	46.8%	0.23
Del Mar	5.02	15.22%	8.99%	0.40	1.71	42.5%	0.17
El Paso	2.88	6.77%	5.94%	0.27	0.76	50.3%	0.47
Frank Phillips	**0.14**	**-3.90%**	**-4.82%**	0.16	0.62	74.7%	0.18
Galveston	6.92	8.04%	9.46%	0.61	7.56	84.4%	0.05
Grayson	5.95	11.22%	8.57%	0.70	2.36	42.7%	0.27
Hill	6.18	11.13%	11.04%	0.44	3.48	74.1%	0.10
Houston	3.52	17.53%	17.27%	0.24	**0.17**	31.4%	1.51
Howard	5.42	7.56%	3.15%	0.33	3.99	58.9%	0.07
Kilgore	6.44	6.26%	9.28%	0.50	8.49	89.9%	0.03
Laredo	3.30	11.81%	8.44%	0.34	**0.26**	20.3%	**2.42**
Lee	3.23	10.59%	6.80%	0.25	0.64	51.5%	0.22
Lone Star	2.64	9.38%	1.23%	0.20	1.19	28.6%	0.21
Mclennan	2.41	9.67%	3.69%	0.17	0.55	30.6%	0.49
Midland	4.00	5.19%	4.44%	0.40	2.13	61.0%	0.10
Navarro	3.29	11.70%	8.88%	0.27	0.48	45.8%	0.65
North Central Texas	5.23	5.96%	5.62%	0.50	2.99	76.4%	0.17
Northeast Texas	2.40	9.33%	4.17%	0.18	0.47	33.9%	0.49
Odessa	5.12	17.46%	16.19%	0.55	1.11	27.3%	0.55
Panola	6.28	11.93%	11.61%	0.63	2.91	70.4%	0.18
Paris	4.41	11.42%	12.39%	0.55	0.98	58.2%	0.49
Ranger	7.66	32.97%	13.14%	0.44	7.64	63.2%	0.10
San Jacinto	4.51	4.00%	**-3.97%**	0.38	13.16	36.9%	0.02
South Plains	2.79	2.99%	3.11%	0.20	1.81	78.7%	0.13
South Texas	8.34	14.03%	15.20%	0.93	108.67	80.3%	0.00
Southwest Texas	2.19	1.41%	2.16%	0.32	1.08	46.9%	0.59
Tarrant	6.63	5.62%	11.56%	0.60	54.57	92.9%	-
Temple	5.62	18.32%	11.05%	0.52	1.70	38.9%	0.34
Texarkana	2.20	0.81%	0.71%	**0.12**	2.02	78.1%	-
Texas Southmost	4.75	7.36%	7.77%	0.59	1.76	48.2%	0.21
Trinity Valley	5.04	4.07%	4.38%	0.19	5.75	88.7%	0.03
Tyler	2.59	7.56%	10.47%	0.22	**0.30**	51.6%	0.61
Vernon	2.10	3.65%	4.79%	0.26	0.45	48.4%	0.65
Victoria	**0.43**	**-1.61%**	**-2.15%**	0.15	0.59	60.6%	0.29
Weatherford	6.48	3.57%	3.74%	0.79	12.42	74.7%	0.05
Western Texas	3.31	15.57%	13.56%	0.17	**0.37**	54.6%	0.49
Wharton	6.42	6.31%	6.65%	0.51	5.53	74.9%	0.08
Statewide	3.63	7.10%	7.32%	0.40	1.03	49.5%	0.33

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This document is available on the Texas Higher Education Coordinating Board Website: http://www.thecb.state.tx.us.

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