College for all Texans

Texas Higher Education
Coordinating Board

Financial Condition Analysis of Texas Public Community College Districts

Texas Institutions of Higher Education

May 2015

Strategic Planning and Funding

Texas Higher Education Coordinating Board

Mission, Vision, Philosophy, and Core Values

Agency Mission

The Texas Higher Education Coordinating Board promotes access, affordability, quality, success, and cost efficiency in the state's institutions of higher education, through *Closing the Gaps* and its successor plan, resulting in a globally competent workforce that positions Texas as an international leader in an increasingly complex world economy.

Agency Vision

The THECB will be recognized as an international leader in developing and implementing innovative higher education policy to accomplish our mission.

Agency Philosophy

The THECB will promote access to and success in quality higher education across the state with the conviction that access and success without quality is mediocrity and that quality without access and success is unacceptable.

The Coordinating Board's core values are:

Accountability: We hold ourselves responsible for our actions and welcome every opportunity to educate stakeholders about our policies, decisions, and aspirations.

Efficiency: We accomplish our work using resources in the most effective manner.

Collaboration: We develop partnerships that result in student success and a highly qualified, globally competent workforce.

Excellence: We strive for preeminence in all our endeavors.

Executive Summary

An annual report about the financial condition of the state's community colleges is required, as referenced in the General Appropriations Act, Senate Bill 1 (S.B. 1), 83rd Texas Legislature, Section 13 (page III-203). The rider states the following:

> "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. This analysis 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 using 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 $1.80 billion since Fiscal Year 2008. Most of the increase is due to the general obligation bonds issued by districts. For Fiscal Year 2014, the combined noncurrent obligations for public community colleges was $4.883 billion. Overall, the public community colleges are managing the growth they have experienced. This is reflected in the increase in net position of $168 million in Fiscal Year 2014 over Fiscal Year 2013. Net position has increased $1.6 billion since Fiscal Year 2008 to $5.772 billion in Fiscal Year 2014. Expendable net position for Fiscal Year 2014 is $2.176 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) has been 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 a leverage ratio.

The institutions were given an opportunity to provide feedback. There were not any received.

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. Nine of the existing districts do not meet that rule.

To a significant degree, local control enables 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 districts receive is from four sources: state formula funding, local property tax revenue, tuition and fee revenue, and other income that is largely from federal funds. Although some districts have endowments, they are more commonly found in universities, and revenue from endowments 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 that can form a basis for sound planning.

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 with these 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. Many institutions, including the U.S. Department of Education, the State of Ohio Board of Regents, credit rating agencies, and countless institutions of higher education employ the index or similar approaches.

The CFI blends four core financial ratios into one metric, providing a more balanced view of an institution's finances since weakness in one measure can be offset by

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[1] Texas Research League, *Bench Marks for Community and Junior Colleges in Texas*, August 1993.

[2] For more information, see *Strategic Financial Analysis for Higher Education*, 6th edition, KPMG, Prager, Sealy & Co., Bearing Point, 2005.

strength in another. Additionally, measuring the index over time provides a glimpse of the progress institutions are making toward achieving financial goals.

The Texas Higher Education Coordinating Board has been calculating the CFI and sharing related data with the community college districts since 2007. The CFI 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 position generated by operating revenue?" The 2014 statewide ratio for public community colleges is .44, which is an increase from .39 in 2013. A ratio of 0.14 or greater is the standard used in this report. The standard was met by 47 of the 50 districts.

<u>Viability Ratio</u> – measures the financial health of the institution by comparing total expendable net assets to certain noncurrent liabilities. The 2014 statewide ratio for public community colleges is 1.16, which is an increase from 1.08 in 2013. A ratio of 0.42 or greater is the standard used in this report. The standard was met by 42 of the 50 districts.

<u>Return on Net Position</u> – measures total economic return during the fiscal year. The 2014 statewide ratio for public community colleges is 3.00 percent, which is a decrease from 3.86 percent in 2013. A positive return is the standard used in this report. The standard was met by 40 of the 50 districts.

<u>Operating Margin</u> – indicates an operating surplus or deficit in the given fiscal year. The 2014 statewide margin for public community colleges is 5.90 percent, which is an increase from 5.13 percent in 2013. A positive margin is the standard used in this report. The standard was met by 41 of the 50 districts.

<u>Composite Financial Index</u> – 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 2014 combined CFI for public community colleges is 3.27, which is an increase from 3.06 in 2013. An index number of 2.0 or greater is the standard used in this report. The standard was met by 37 of the 50 districts.

Appendix A provides more detail about 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.

<u>Equity Ratio</u> – An equity ratio is a comparison of net assets to total assets and is used when institutions have no outstanding indebtedness. The 2014 statewide ratio for public community colleges is 48.8 percent, which is an increase from 48.1 percent in 2013. A ratio of 20 percent or greater is the standard used in this report. The standard was met by 48 of the 50 districts.

<u>Leverage Ratio -</u> 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 2014 statewide ratio for the public community colleges is .28, which is a decrease from .32 in 2013. 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 B contains the indicators for the 50 districts for Fiscal Year 2014. An Excel workbook is available that contains all of the financial data used for the indicators and includes data for Fiscal Years 2003 to 2014.

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-five of the 50 public community college districts have little or no indication of financial stress, which is the same as Fiscal Year 2013. Thirty of the 45 districts meet the threshold for all indicators. They are adequately capitalized, adding positive net position balances, and are properly positioned for future success. The remaining 15 do not meet the threshold for two or fewer indicators.

Six institutions do not meet the threshold for three or more of the indicators. The number of institutions in this category has remained the same since Fiscal Year 2013. A discussion of these institutions follows.

- Austin Community College (ACC) did not meet five of the indicator thresholds. The ratios that include noncurrent debt — the equity, leverage, and viability ratios — are all below the standard used for this report. The CFI and return on net assets were both negative. The college has not utilized general obligation bonds during the recent expansions, which have been excluded from the noncurrent 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 five of the indicator thresholds. The return on net position and operating margin were negative. Net position fell $679 thousand, which lowered the primary reserve below the state standard ratio of .14 or greater. In the previous four years, the college has had a negative operating margin and has not met the 2.0 threshold on the CFI.

- Alamo College did not meet three of the indicator thresholds. The return on net position and operating margin were negative for the second time since Fiscal Year 2011. Net position fell $2.5 million, which lowered the institution's CFI below the standard of 2.0.

- Cisco College did not meet three of the indicator thresholds. The return on net position and operating margin were negative. The CFI fell below the 2.0 threshold.

- Laredo College did not meet three of the indicator thresholds. For Fiscal Year 2014, the equity, leverage, and viability ratios were all below the standard used for this report.

- Navarro College did not meet three of the indicator thresholds. The return on net position was negative, and the institution's CFI slipped below the standard of 2.0. The college's reduction of $3.5 million in expendable and unrestricted net position dropped the institution's viability ratio below the state standard.

Summary

The single best method to assess the overall financial condition is using the CFI. While there is variability in the statewide CFI looking at a year to year comparison, the overall financial condition of public community colleges has improved in the last five years with the statewide CFI increasing from 2.74 to 3.27.

Evaluating the overall state financial health in regards to individual indicators is more turbulent and the individual indicators are better used to assess an individual institution, either for a given year or on a longitudinal assessment. However, looking at the individual indicators on an aggregate basis is not without value despite the year to year variability. As can be seen in the table below, Fiscal Year 2014 saw 48 of 50 institutions meeting four or more individual indicators of financial health. Only two institutions met less than three indicators.

	FY 2014	FY 2013	FY 2012	FY 2011	FY 2010
Met all 7 indicators	30	31	39	33	22
Met 6 indicators	5	5	6	8	10
Met 5 indicators	10	7	1	4	6
Met 4 indicators	4	3	2	2	7
Met 3 indicators	0	2	1	1	5
Met 2 indicators	2	2	1	2	0
Statewide CFI	3.27	3.06	3.63	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.

Equity ratio – measures capital resources available and a college's ability to borrow. The U.S. Department of Education (DOE) introduced this ratio in place 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.

Net assets / 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.

Long term debt* / Total net assets

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

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.

Total income – total operating expense / 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?"

Total expendable net assets + unrestricted net assets / Operating expenses + interest expense on debt*.

*Interest expense on debt includes all debt, both tax and other revenue supported.

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?"

Change in net assets / Total net assets (beginning of year)

Viability Ratio – measures the financial health of the institution by comparing total expendable net assets to total noncurrent 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?"

Total expendable net assets + unrestricted net assets / Noncurrent liabilities, excluding general obligation (GO) debt

Appendix B: Composite Financial Index, Core Financial and Other Ratios

Fiscal Year 2014 General Obligation Bond Debt Excluded

Financial Stress Indicators	District	Composite Financial Index	Return on Net Position	Operating Margin	Primary Reserve	Viability Ratio	Equity Ratio	Leverage Ratio
3	Alamo	**0.88**	**(0.01)**	**(0.01)**	0.257	0.48	30.4%	0.32
2	Alvin	4.20	0.04	**(0.01)**	**0.140**	35.74	48.7%	-
2	Amarillo	3.48	**(0.50)**	**(0.02)**	0.407	6.64	52.1%	0.04
0	Angelina	5.67	0.06	0.03	0.392	26.46	64.8%	0.01
5	Austin	**0.02**	**(0.08)**	0.02	0.152	**0.12**	**11.9%**	**5.00**
0	Blinn	2.98	0.08	0.08	0.220	0.69	57.3%	0.32
0	Brazosport	3.73	0.10	0.05	0.224	1.69	36.2%	0.13
0	Central Texas	6.07	0.00	0.01	0.920	91.56	86.4%	-
3	Cisco	**0.76**	**(0.01)**	**(0.00)**	0.188	0.44	46.9%	0.66
2	Clarendon	**1.88**	**(0.01)**	0.01	0.390	0.86	67.5%	0.07
2	Coastal Bend	2.95	0.16	0.07	**0.058**	**0.17**	40.2%	0.72
2	College Of The Mainland	4.25	**(0.01)**	**(0.01)**	0.368	7.63	75.2%	-
0	Collin	8.49	0.05	0.12	1.552	60.93	87.5%	0.01
0	Dallas	6.81	0.09	0.12	0.522	12.60	51.7%	-
0	Del Mar	4.37	0.10	0.06	0.480	1.46	49.8%	-
0	El Paso	3.91	0.09	0.08	0.381	1.19	62.2%	0.35
5	Frank Phillips	**(0.51)**	**(0.05)**	**(0.06)**	**0.062**	**0.32**	74.8%	0.15
0	Galveston	6.52	0.06	0.07	0.534	36.59	88.8%	-
0	Grayson	5.44	0.07	0.04	0.755	2.61	49.0%	0.22
0	Hill	6.41	0.07	0.08	0.458	5.44	79.5%	0.06
1	Houston	3.05	0.10	0.08	0.305	**0.26**	25.1%	1.21
0	Howard	2.73	0.06	0.03	0.379	0.94	53.4%	0.31
0	Kilgore	5.42	0.01	0.02	0.547	15.19	91.1%	0.02
3	Laredo	2.78	0.05	0.09	0.376	**0.30**	**14.9%**	**2.15**
2	Lee	**0.93**	0.00	**(0.01)**	0.207	0.58	36.2%	0.22
0	Lone Star	2.21	0.01	0.12	0.211	0.65	27.9%	0.52
0	Mclennan	2.08	0.06	0.01	0.201	0.96	34.9%	0.28
0	Midland	3.80	0.04	0.04	0.463	2.04	64.5%	0.12
3	Navarro	**0.87**	**(0.01)**	0.01	0.176	**0.39**	49.3%	0.53
0	North Central Texas	5.49	0.04	0.04	0.477	3.86	63.6%	0.12
2	Northeast Texas	**1.17**	0.03	**(0.00)**	0.177	0.47	38.0%	0.51
0	Odessa	5.20	0.12	0.13	0.610	1.63	32.0%	0.36
0	Panola	8.26	0.20	0.12	0.669	5.31	63.7%	0.09
0	Paris	2.95	0.02	0.05	0.465	0.90	61.4%	0.42
0	Ranger	5.11	0.30	0.16	0.483	0.99	46.1%	0.66
2	San Jacinto	3.78	**(0.03)**	**(0.09)**	0.361	14.78	38.1%	0.01
1	South Plains	**2.00**	0.03	0.03	0.213	0.84	68.6%	0.30
0	South Texas	8.06	0.07	0.10	1.091	2,179.29	74.3%	-
0	Southwest Texas	2.94	0.03	0.04	0.551	0.73	33.1%	1.48
0	Tarrant	6.38	0.04	0.07	0.575	23.28	93.4%	-
0	Temple	3.77	0.05	0.03	0.534	1.77	43.8%	0.27
1	Texarkana	**1.81**	0.01	0.01	0.182	1.41	73.2%	-
0	Texas Southmost	10.00	0.24	0.11	1.432	4.52	58.1%	0.12
1	Trinity Valley	**1.55**	0.04	0.04	0.231	**-**	95.1%	-
2	Tyler	**1.61**	0.02	0.06	0.171	**0.15**	38.1%	1.00
2	Vernon	**1.09**	**(0.00)**	0.02	0.206	0.44	49.3%	0.61
0	Victoria	4.78	0.05	0.00	0.281	8.20	46.3%	0.04
0	Weatherford	4.40	0.04	0.03	0.678	2.16	66.0%	0.24
1	Western Texas	4.15	0.19	0.18	0.379	**0.32**	43.5%	1.00
0	Wharton	7.01	0.10	0.10	0.575	10.00	79.5%	0.05
0	Statewide	3.27	0.03	0.06	0.437	1.16	48.8%	0.28

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

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