UPDATE TO
THE 7TH EDITION OF
STRATEGIC FINANCIAL ANALYSIS
IN HIGHER EDUCATION
SUMMER 2016
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OUR RATIONALE FOR THIS UPDATE
INTRODUCTION
The first of seven editions of Strategic Financial Analysis for Higher Education was published in 1980 as Ratio Analysis in Higher Education. The importance of the concepts and tools defined in these publications has been acknowledged by higher education leaders and has been used extensively by trustees and senior managers as well as financial and credit analysts.

Our Rationale for this Update
The Seventh Edition in the series, Identifying, Measuring & Reporting Financial Risks (SFA 7), was published in 2010 and reflected our observations that a paradigm shift occurred after the 2008 financial crisis with respect to financial management of higher education institutions. We concluded that historical methods of monitoring institutional financial health, mitigating risks, and reporting on those risks needed updating.

There have been significant changes moreover, since 2010, in financial reporting and management by both private and public institutions of higher education. We have received numerous similar requests and inquiries from both such institutions about the calculation of certain ratios given specific conditions, transactions or events. We continue to believe, however, that the ratios presented in SFA 7 are key components to measure institutional financial health, but we learned from these inquiries that certain ratio calculations or terms needed clarification. Credit rating agencies have also updated their methodologies to reflect changes in credit markets as well as financial reporting and management.

The Authors believe that a brief update is needed at this time. A new edition is not warranted since there are significant pending changes to financial reporting standards for private institutions, and public institutions are still implementing and disclosing changes to reporting obligations for pensions and other post-employment benefits. We will continue to monitor these developments and assess their impact on financial analytical tools and benchmarks.

This document should be considered in the context of SFA 7, where the concepts discussed therein are developed more fully.

This update will address the following topics:

- Conceptual Framework of the Ratios and Expendable Net Assets/Net Position
- Calculating Expendable Net Assets and Net Position
- Using the Ratios in Trend and Peer Group Analyses
- Ratio Flexibility, Clarifications and Other Errors
- Evolving Credit Rating Agencies’ Methodologies
- Public Institutions and Post-Employment Obligations
- Upcoming and Potential Changes for Private and Public Institutions

The inquiries have shown a common point of confusion centers on the conceptual framework for the financial analysis tools and ratios, how they were developed, and their rationale.
For private institutions, the Financial Accounting Standards Board (“FASB”) has proposed significant changes to the financial reporting model originally promulgated in Accounting Standards Section 958.205, Not-for-Profit Entities, Presentation of Financial Statements (formerly Statement of Financial Accounting Standards No. 117, Financial Statements of Not-for-Profit Organizations, published in 1993). A final Accounting Standards Update (ASU) is expected in August 2016. While these deliberations are continuing, the changes that are being considered may have a significant effect on the financial statements of private institutions. These proposed changes have been highlighted sufficiently by industry finance personnel so we will not comment on them here. However, some changes may render certain elements used in our financial analysis tools more difficult or impossible to obtain. We will monitor these developments closely to determine what effect such proposed changes may have to our financial analysis tools.

While substantial modifications to the reporting model for private institutions are in progress, there are other financial and reporting changes since SFA 7 that impact the computation of the ratio, which we will comment on in this update.

Evaluating the recent GASB changes and the recent and upcoming FASB changes will take some time. These changes may affect both the way we calculate the ratios as well as the benchmarks used, including the scoring scale and weighting factors used in the CFI. We will continue to monitor these developments and intend to publish an Eighth Edition at an appropriate time.
Prior editions introduced several financial ratios that would effectively communicate financial information and answer several basic questions:

- Is the institution financially healthy or not at the reporting date?
- Is the institution better off than it was in the prior year?
- Did the institution live within its means during the year?
- What financial resources does the institution have to fulfill its mission?

These primary questions address whether there is sufficient equity to meet debt obligations and cover annual operating expenditures. We developed two ratios as a response: the Viability Ratio addressed debt obligations and the Primary Reserve Ratio addressed operating commitments. These ratios analyze and use only the amount of equity (i.e., fund balances, net assets or net position) that may be expended for operating purposes and debt obligations, rather than all equity, including those funds that have to be maintained in perpetuity or used for capital asset purposes. In order to calculate the ratios, we segregate total equity into its various components, namely those that could be expended for future operating purposes and debt obligations (expendable funds) and those that could not (non-expendable funds). Non-expendable funds generally reside in bricks and mortar as plant assets or in perpetuity for the benefit of the institution (e.g., true endowment funds). Further, restricted funds held for capital acquisition purposes are classified as non-expendable.

The Viability Ratio represents expendable equity to debt and is similar to that ratio used by for-profit entities. The Primary Reserve Ratio is an important measure of financial health since expendable equity should grow at least in proportion to operating size, determined as total expenses. It also serves as a check on the Viability Ratio since an institution may have limited expendable net assets or debt.

Over time, the accounting concepts evolved from fund groups within the financial statements to the institution as a whole with individual fund groups no longer presented in the financial statements. For private institutions, net assets represent equity and generally have a one-to-one relationship to fund balances. Some fund balances, like agency funds and refundable student loan funds from the U.S. Government, are considered liabilities. For public institutions, the fund groups are also combined into institution-wide totals with fund balances reported as net position. These net positions consist of amounts invested in plant, expendable net position, and non-expendable net position.

Our approach has remained consistent with changes in accounting concepts: namely, how much expendable equity is there to cover debt and operating expenses. The concepts are the same for both public and private institutions although the nomenclature differs.

Our financial analysis tools evolved to respond to higher education financial environment issues and needs. The 2008-2009 liquidity crisis demonstrated that colleges and universities underestimated the issue of liquidity in terms of availability or cost. As a result, there still remains a focus on liquid at all institutions. Although the emphasis on liquidity will vary, every institution should have an analytical and managerial framework to treat liquidity effectively. The impact of...