MINNESOTA STATE
Board of Trustees

AGENDA ITEM SUMMARY

NAME: Finance and Facilities Committee **DATE:** January 24, 2023

TITLE: College and University Financial Performance Update

☐ Proposed New Policy or Amendment to Existing Policy ☐ Approvals Required by Policy ☐ Other Approvals

☒ Monitoring/Compliance ☐ Information

PRESENTERS
William Maki, Vice Chancellor for Finance and Facilities
Denise Kirkeby, System Director for Financial Reporting
Steve Ernest, System Director for Financial Planning and Analysis

PURPOSE
A brief review of the Minnesota State fiscal year 2022 and fiscal year 2021 financial statement results, summary of college and university fiscal year 2022 financial health indicators per Board Procedure 7.3.16, and potential revisions to Board Procedure 7.3.16 based on experience and recent review.

BACKGROUND INFORMATION

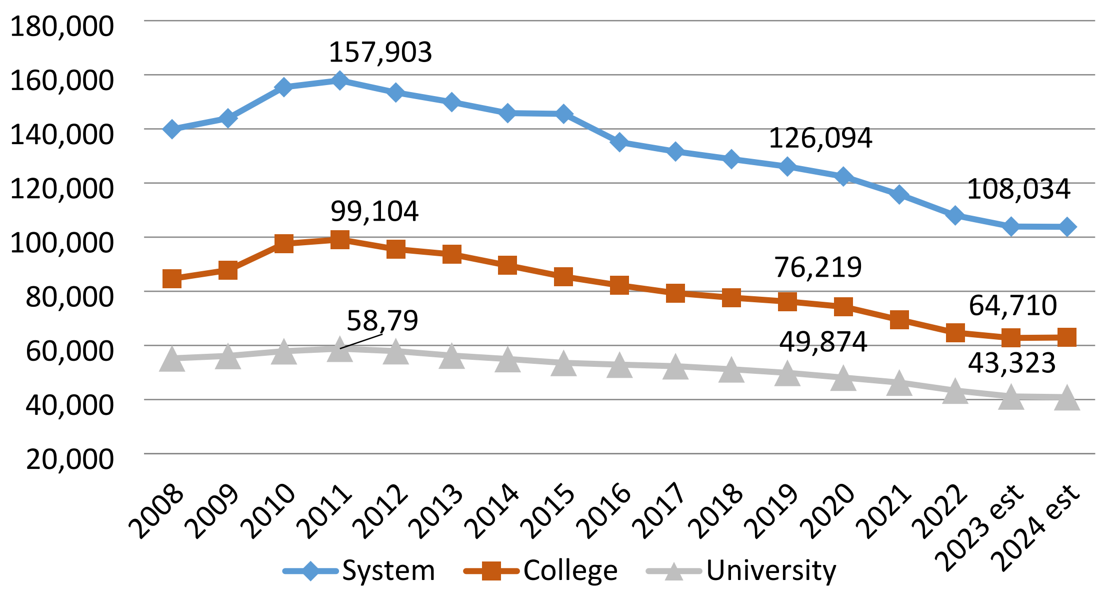
In November, the system's Audited Financial Statements for fiscal year 2022 were presented to the Audit Committee. This annual report will briefly recap the 2022 financial statement results and then present the 2022 financial health indicator results as provided for in System Procedure 7.3.16. Linking the two is the Composite Financial Index (CFI) measure, which is calculated at the system level and for each institution.

The Audited Financial Statements and the financial health indicators support the conclusion that the system's financial health is stable. Looking at individual measures, two of the most significant factors affecting both sets of results are enrollment and federal pandemic assistance. Declines in enrollment, exacerbated by the pandemic, caused significantly lower revenues in tuition and other areas. An influx of one-time federal assistance was able to fill in for those revenue losses to a large degree, but this assistance partially masks the significance that lower enrollment normally has on financial health. With prudent financial management, colleges and universities have successfully maintained educational operations, but continued declining enrollment remains a concern for most.

ENROLLMENT

Graph 1 shows enrollment history and projections as of the October 2022 budget update.

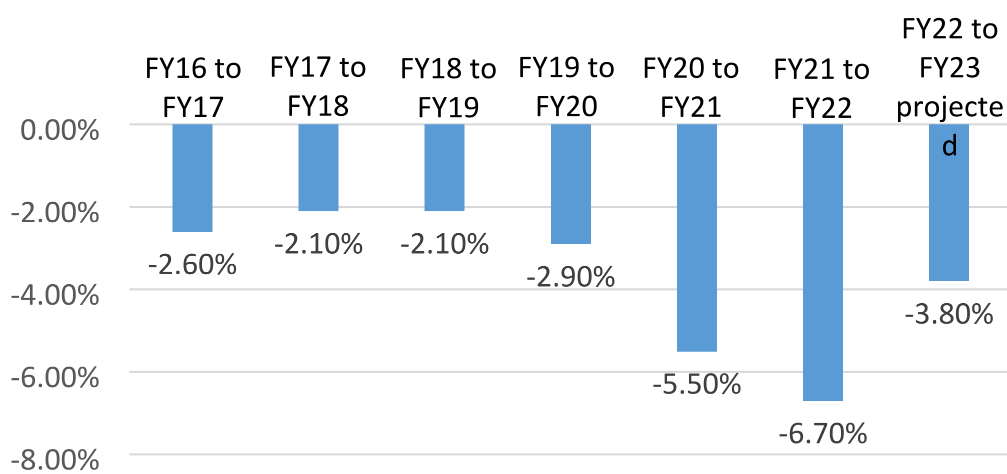
Graph 1. Historical and Projected Enrollment for the System



It is important to note that the system was already experiencing a decade-long decline in enrollment before the March 2020 pandemic. While most colleges and universities are projecting that enrollment will begin to stabilize next year, enrollment will continue to be one of the most important variables for maintaining financial health.

Graph 2 shows annual enrollment declines for the system.

Graph 2. Annual Enrollment Declines for the System



The decline in enrollment from fiscal year 2021 to fiscal year 2022 was 6.7 percent, annual declines in the proceeding five years ranged from 2.1 percent to 5.5 percent each year. Current projections estimate that the fiscal year 2022 to fiscal year 2023 decline will be 3.8 percent. Fiscal year 2023 updated enrollment projections will be presented later this spring. Efforts to analyze and address enrollment patterns are complex due to the multitude of factors that impact them such as demographics, the labor market, and the pandemic.

FEDERAL HIGHER EDUCATION EMERGENCY RELIEF FUNDS

Beginning in spring 2020, the colleges and universities of Minnesota State have individually been awarded federal Higher Education Emergency Relief Funds (HEERF) that together total over $600 million. During fiscal years 2020 through 2022, roughly $240 million was used in campus budgets to replace revenues lost due to the pandemic and to make sure institutions could provide alternative instructional delivery (online or hybrid learning) to continue operations. These funds went a long way in being able to support the two overarching commitments Minnesota State made during the pandemic: safeguarding the health, safety, and welfare of faculty, staff, and students and enabling students to continue progress towards their educational goals through quality, accessible education and services. Table A shows the use of HEERF dollars in fiscal years 2020 through 2022.

Table A. Federal HEERF Use FY2020-FY2022

	Response Funding for Institutions	Direct Grants to Students
FY2020	$14 million	$43 million
FY2021	$97 million	$59 million
FY2022	$129 million	$194 Million

Fiscal year 2023 is that last year that HEERF assistance is available and roughly $70 million in HEERF is included in this year's budgets. Of that, at least $6 million has already gone out in direct student grants, bringing the four-year total granted to students so far to over $300 million.

When HEERF assistance is used by institutions to weather the unusual and unforeseen financial challenges caused by the pandemic, much of that takes the place of spending fund balance for response activities. If not for the one-time assistance federal HEERF dollars provided in the way of lost revenue replacement and pandemic response expenses, more institutions would have been forced to utilize fund balance dollars in these years. Looking ahead, the ending of this financial support in fiscal year 2023 is not likely to correspond with an end of the enrollment concerns, meaning fund balance use will likely increase in the coming year or two. As a result, this will put financial pressures on many institutions as on-going revenues will need to replace one-time funds or spending reductions will be needed to have a structurally balanced budget.

MEASURES OF FINANCIAL HEALTH

There are several ratios derived from audited financial statements that are used to help assess an institution's financial health. The Composite Financial Index (CFI) is a combination of four key financial ratios and part of why it is valuable to know is because it is widely used throughout higher education. The CFI score focuses on the ability of the institution's financial reserves to withstand unexpected pressures, the ability of the institution to pay off debts, how much the institution's assets have grown in the past year, and how well revenues matched expenses in the past year. The specific ratios included in the CFI score are:

1. The *primary reserve ratio* measures spendable resources on hand compared to the prior year's expenses. (35% weight)
2. The *viability ratio* measures spendable resources on hand compared to total debt and obligations for facilities. (35% weight)
3. The *return on net asset ratio* measures the change in net assets during the prior year compared to where they were at the beginning of the year. (20% weight)
4. The *operating margin ratio* measures the difference between revenues and expenses in the past year as a percentage of those revenues. (10% weight)

Each ratio on its own provides a valuable measure of financial health. When the four are combined and weighted (more heavily on the first two than the second two), the resulting CFI score is the most commonly used measure of financial health for higher education institutions. The system office calculates these values at the end of each year. An adjusted CFI score (separating out pension and other retirement benefits) averaging less than 1.5 over a 2-year period, or less than 0.5 in the most recent year triggers follow-up consultation. For institutions that trigger this indicator, system leadership partners with institutional leadership to better understand specific institutional concerns and plans to ensure financial health going forward.

More readily accessible than financial statement ratios, and often of more immediate importance, are measures of enrollment levels and general fund balance levels. Minnesota State's General Fund contains tuition revenues, state appropriation dollars, and other funds not dedicated or segregated for distinctly separate operations like unique facilities or activities. In addition to CFI, measures included in System Procedure 7.3.16 Financial Health Indicators are:

Enrollment based indicators

- A1. Long-term enrollment: triggered for follow-up by a decline of more than 8 percent over two years
- A2. Short-term enrollment: triggered for follow-up by a shortfall more than 2 percent compared to the change projected in the institution's annual budget

Cash-based indicators

- B1. General fund cash balance: triggered for follow-up by a cash balance of less than 20 percent of annual general fund revenue
- B2. General fund utilization: triggered for follow-up by a general fund balance decline of 10 percent or more over the most recent three-year period

Fiscal year 2022 measures for the system are described below. When any of these measures is triggered for follow-up, system procedure requires schools to prepare reports and plans to be reviewed with System Office leadership.

FISCAL YEAR 2022 FINANCIAL STATEMENT RESULTS

As was presented to the board in November, the Audited Financial Statements for fiscal year 2022 showed slight improvement compared to the fiscal year 2021 results. The system's overall financial position increased by $256.6 million in fiscal year 2022. Excluding the GASB Statements No. 68 and No. 75 effect, fiscal years 2022 and 2021 net position increased by $60.5 million, or 2.5 percent and $23.9 million or 1.0 percent, respectively. Changes in the main revenue and expenditure areas include the following.

- Income (loss) before other revenues, expenses, gains, or losses, experienced a gain of $221.2 million and a loss of $20.0 million in fiscal years 2022 and 2021, respectively. This compares to a loss of $41.7 million in fiscal year 2020. Excluding the effects of GASB Statements No. 68 and No. 75, the system experienced a gain of $25.1 million in fiscal year 2022, with losses of $6.6 million and $24.0 million in fiscal years 2021 and 2020, respectively.

- Compensation, the largest cost category in the system, decreased $232.5 million, or 16.5 percent, in fiscal year 2022 and decreased $9.1 million, or 0.6 percent, in fiscal year 2021. Excluding the GASB Statements No. 68 and No. 75 adjustments, the net decrease in compensation was $21.3 million, or 1.5 percent, and a net decrease of $4.8 million, or 0.3 percent, in fiscal years 2022 and 2021, respectively. This cost constitutes 62.3 percent of the system's fiscal year 2022 total operating expenses, compared to 68.7 percent for fiscal year 2021.

- The state appropriation and tuition charged to students are the system's two largest revenue sources. The state appropriation increased by $27.4 million, or 3.6 percent, in fiscal year 2022 following an 0.8 percent increase in fiscal year 2021. Most of the fiscal year 2022 increase was for colleges and universities support.

- Gross tuition revenue decreased $9.3 million, or 1.2 percent, in fiscal year 2022. This is compared to a decrease of $27.3 million, or 3.5 percent, and an increase of $3.6 million, or 0.5 percent, in fiscal years 2021 and 2020, respectively. Undergraduate tuition rates for two-year colleges increased by 3.3 percent on average and for state universities increased by 3.5 percent in fiscal year 2022. This follows tuition rates increasing 3.0 percent at two-year colleges and at state universities in fiscal year 2021. However, increases were not effective until spring term, with summer and fall rates frozen at fiscal year 2020.

- The number of full year equivalent students is a significant factor driving both tuition revenue and operating expenses. The number of full year equivalent for credit students in fiscal years 2022, 2021 and 2020 totaled 108,034, 115,758, and 122,483, respectively. Enrollment in fiscal year 2022 decreased 6.7 percent from fiscal year 2021. This follows an enrollment decrease of 5.5 percent between fiscal year2021 and 2020.

- Federal grants increased by $171.8 million, or 42.1 percent in fiscal year 2022 compared to fiscal year 2021, following an increase of $64.6 million, or 18.8 percent in fiscal year 2021 compared to fiscal year 2020. This increase is primarily attributable to $334.6 million and $156.2 million in the Higher Education Emergency Relief Fund (HEERF I, II and III) grant revenue in fiscal years 2022 and 2021 respectively. The fiscal year 2021 HEERF grant revenue increase was offset by an approximately $29.0 million Pell grant decrease to account for the smaller total increase to federal grant revenue in that year.

- Financial aid expense increased by $127.4 million or 119.6 percent in fiscal year 2022 compared to fiscal year 2021, following an increase of $11.3 million or 11.9 percent in fiscal year 2021 compared to fiscal year 2020. The fiscal year 2022 and 2021 increases are attributable to additional financial aid disbursements to students financed by HEERF grant revenue.

- Total debt supporting the system's capital asset investment programs decreased in fiscal year 2022 by $47.3 million to a total of $445.4 million, a 9.6 percent decrease. This decrease was primarily due to the repayment of general obligation and revenue bonds of $41.6 million. An additional $56.0 of revenue bonds were refunded. These decreases were offset by $50.3 million of new general obligation and revenue bonds.

- The system has been building up its cash in fiscal years 2021, 2020, and 2019 to adopt a new Enterprise Resource Planning (ERP) system which began implementation in fiscal year 2021. In fiscal year 2022 expenses outpaced revenues by $4.0 million.

The slight increases in both revenues and expenses were largely due to the effect of federal HEERF dollars, but the operating margins remained stable with a $6.6 million operating loss compared to a $20.0 million operating loss the previous fiscal year. Generally speaking, as in the prior year, declining enrollment and declining operating revenues were offset by the influx of HEERF allocations, which reflects national patterns in higher education finance.

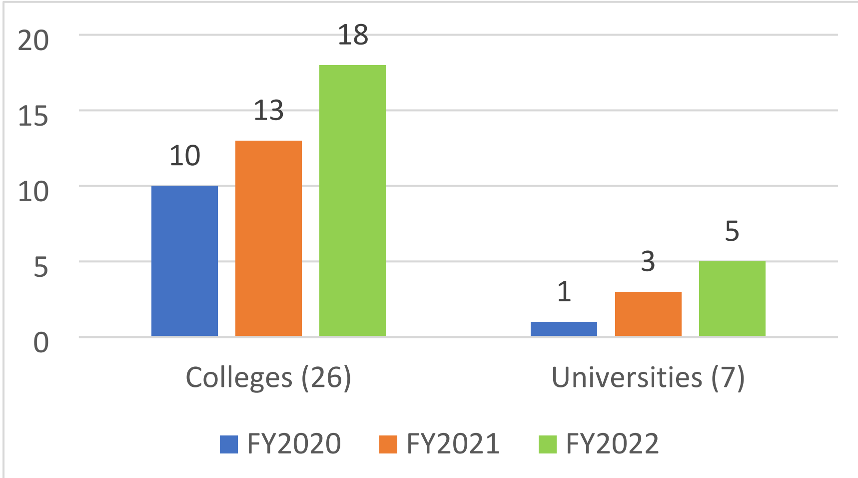
FINANCIAL HEALTH INDICATOR RESULTS

System Procedure 7.3.16 requires examination of the several measures of financial health for individual colleges and universities. The focus of this presentation is on the measures of long-term enrollment change, short-term enrollment change, maintenance of adequate general fund balance, recent use of general fund balance, and Composite Financial Index, CFI. System procedure identifies triggers for each measure which, if triggered, require specific follow-up actions. For historical comparison, the history of Minnesota North's five colleges, which had previously been separately accredited institutions, has been restated as one institution for the charts in this report.

ENROLLMENT-BASED INDICATORS

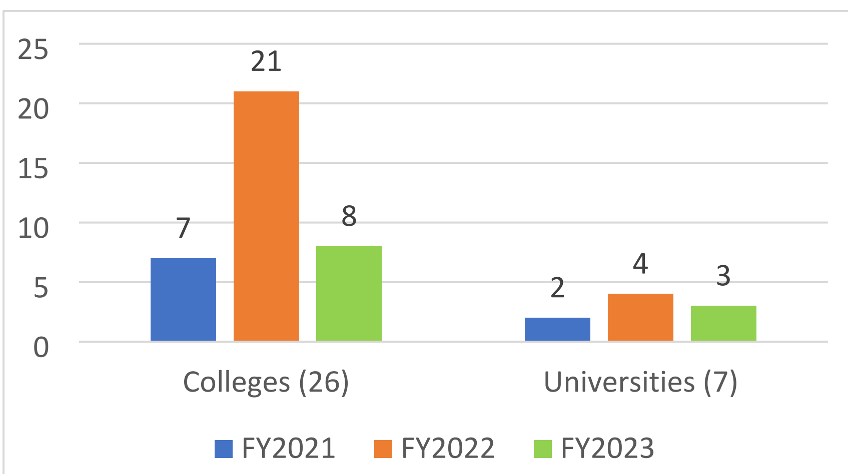
Subpart A1 of the system procedure measures enrollment change over time. For this measure, institutions trigger follow-up action if enrollment has declined more than eight percent over the past two years. Graph 3 shows that eighteen colleges and five universities triggered this measure for fiscal year 2022, numbers worse than fiscal year 2021 and more than twice as many as in fiscal year 2020. As stated above, a significant portion of the recent decline in enrollment does appear to be attributed to the pandemic. Colleges and universities continue to be committed to the implementation of their strategic enrollment management plans.

Graph 3. Enrollment Decline of More than 8% Over 2 Years (A1)



Subpart A2 of the system procedure measures year-to-date enrollment change compared to the annual enrollment change projected in each institution's annual budget when it was approved at the start of the fiscal year. For this measure, institutions trigger follow-up action if the actual year-to-date enrollment change from the prior year is more than two percent lower than the assumption used in the approved operating budget, excluding concurrent enrollment, which is post-secondary instruction delivered off-campus in high schools. Graph 4 shows for fiscal year 2022 that eight colleges triggered this measure, as compared to twenty-one in fiscal year 2021, and three universities triggered this measure as compared to four in fiscal year 2021.

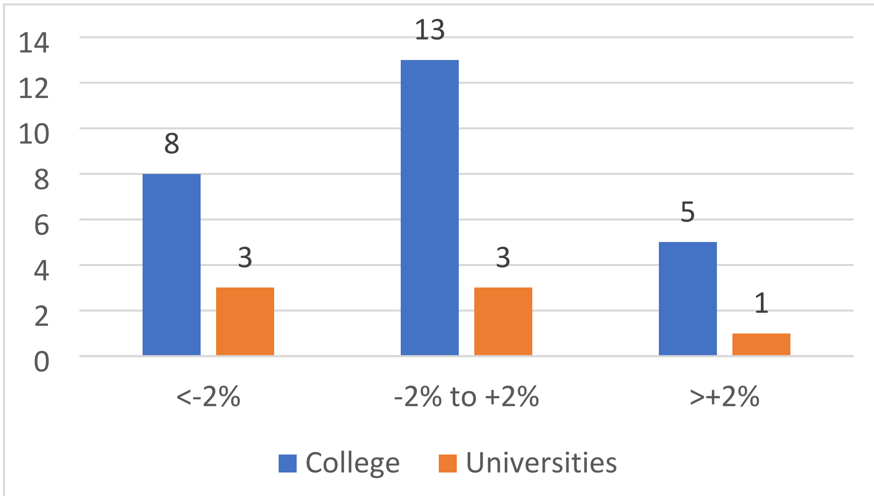
Graph 4. Year-to-date Enrollment Versus Budgeted (A2)



This would suggest that the experience from fiscal year 2021 did give institutions a better ability to predict fiscal year 2022 enrollment, but that it remains difficult to predict enrollment due to the many variables that need to be considered.

Graph 5 shows that thirteen colleges and three universities had fiscal year 2022 enrollment variances within a plus-or-minus two percent band as compared to budgeted enrollment. Five colleges and one university out-performed their budgeted enrollment number by more than two percent.

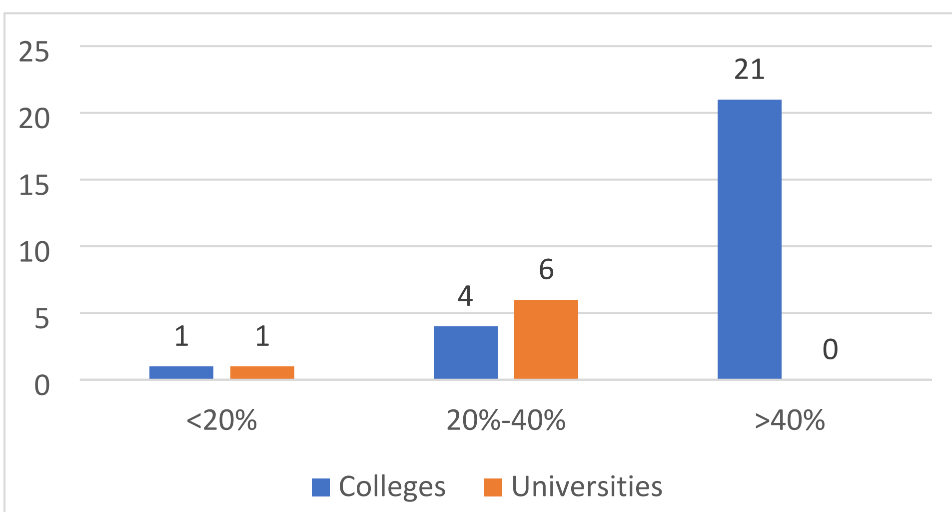
Graph 5. Year-to-date Enrollment Versus Budgeted (A2)



FUND BALANCE-BASED INDICATORS

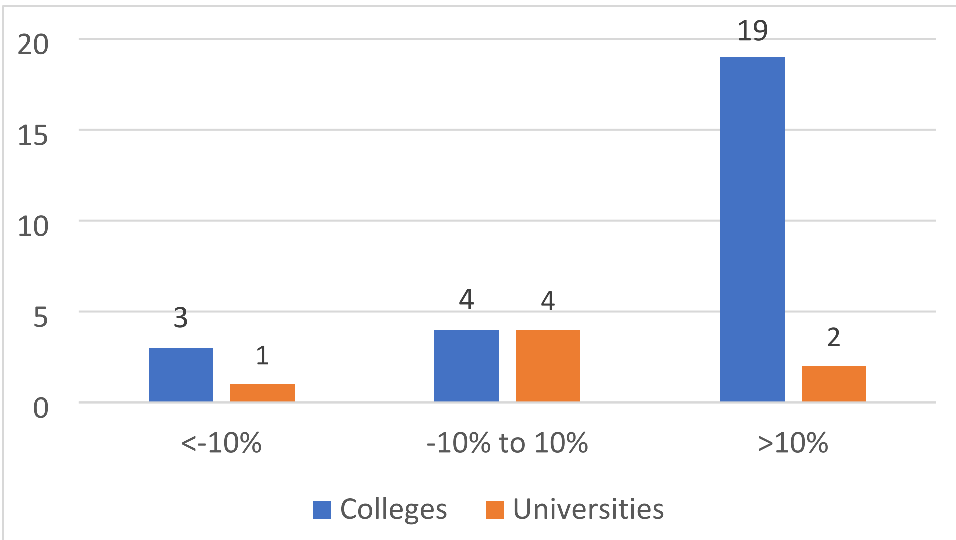
Subpart B1 of the system procedure measures the amount of general fund cash balance each institution has at the end of the fiscal year. For this measure, institutions trigger follow-up action if the cash balance is less than twenty percent of the general fund revenue in that year. As shown in graph 6, one college and one university triggered this measure for fiscal year 2022. Four colleges and the other six universities had fund balances between twenty and forty percent, while most colleges (twenty-one of the twenty-six) had cash balances equal to more than forty percent of the revenue they realized in fiscal year 2022.

Graph 6. Fund Balance Compared to Annual Revenues (B1)



Subpart B2 of the system procedure measures fund balance change over time. For this measure, institutions trigger follow-up action if the year-end general fund cash balance has declined by ten percent or more over the most recent three-year period. As graph 7 shows, three colleges and one university triggered this measure for fiscal year 2022. Four colleges and four universities ended the three-year period between ten percent down and ten percent higher; and nineteen colleges and two universities ended with fund balances more than ten percent higher over the three-year period.

Graph 7. General Fund Balance Change FY2020 to FY2022 (B2)



Triggering this measure sometimes indicates financial distress, but more often than not an institution had been designating fund balances in prior years for a future project or strategic initiative. It is important to compare the results of subpart B1 to this indicator to more fully understand the health of an individual institution's fund balance.

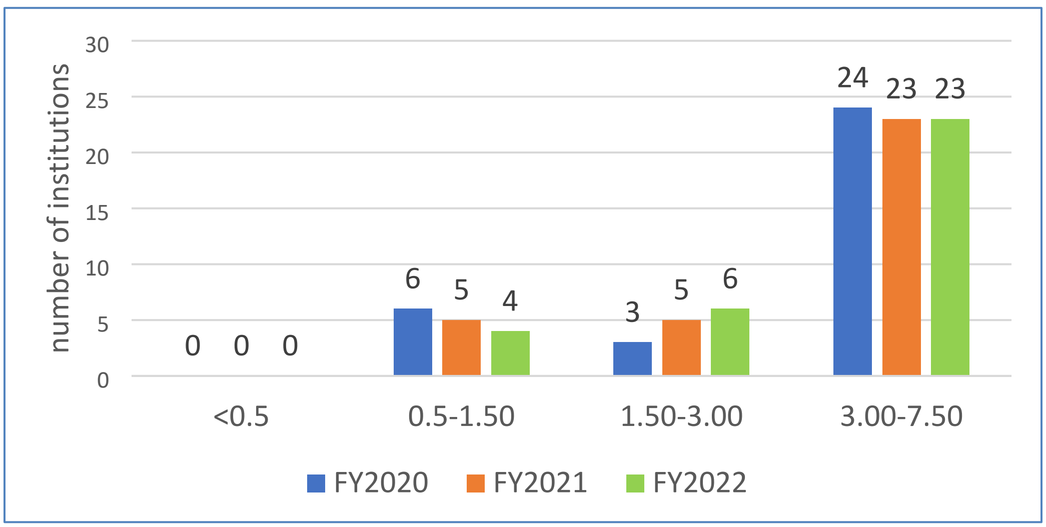
COMPOSITE FINANCIAL INDEX MEASURES

As described above, the CFI measure is derived from the financial statements by combining two ratios of financial position from the system's balance sheet and two ratios of financial operation from the system's income statements. CFI scores by definition range from a negative four to a positive ten. An annual CFI value of below 0.5 indicates that an institution could have issues with viability and survival and requires more intense analysis to make sure the situation is properly managed. A CFI of between 0.5 and 1.5 indicates that an institution needs to be re-engineered to have longer term financial stability. A value of 1.5 to 3.0 is considered to be signify stronger financial health and that the organization has moderate capacity to deal with adversity or invest in innovation and opportunity. A CFI value greater than three represents increasingly stronger financial health and the ability to be transformational and to allow for experimentation and new initiatives. It is important to note that this indicator only measures the financial component of an institution's well-being and it must be analyzed in that context, especially with the achievement of mission.

While CFI measures are only operational at the individual institution level, the combined CFI measure for the system also provides a sense of financial health overall. From fiscal year 2021 to fiscal year 2022, the overall CFI for the system improved slightly from 2.70 to 3.28 when excluding the provisions of the Governmental Accounting Standards Board (GASB) Statements 68 and 75. These provisions address long-term pension and other post-employment benefit obligations which may have significant volatility due to projections of future values of invested funds and actuarial projections of the members covered by each of those retirement funds. In order to focus on nearer-term financial health, it is useful to look at the CFI without the effects of these retirement-related provisions. When including these provisions, the system's CFI has improved from a 0.41 to a 3.62 CFI score. As a reminder, the audited financial statements use the full accrual method of accounting, so non-cash items like depreciation are included on the expense side and the ratios used in the CFI scores measure operating positions from a non-cash basis.

Looking at CFI results at the institutional level, Graph 8 summarizes the fiscal year 2022 CFI scores for the system's colleges and universities.

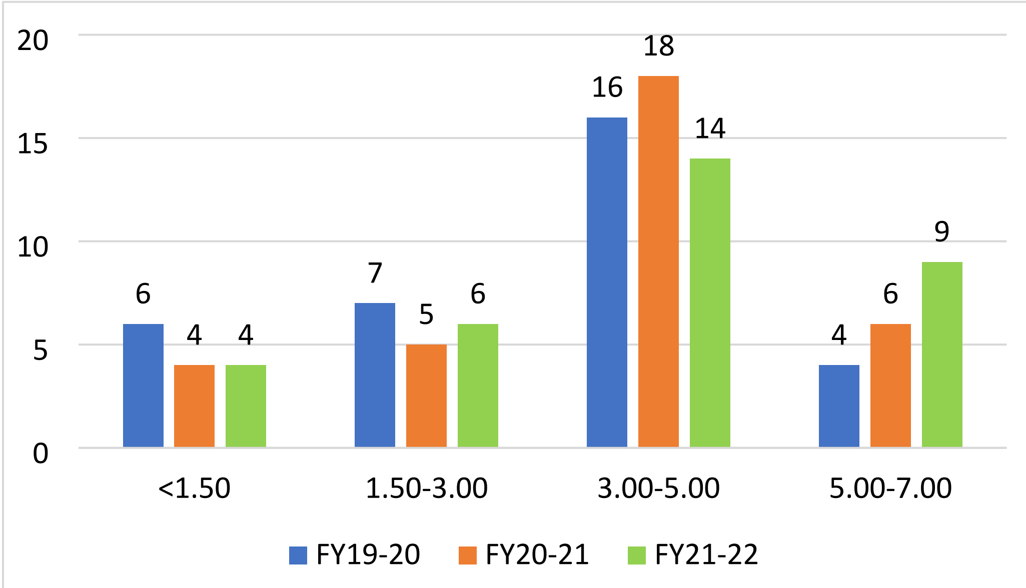
Graph 8. Annual Composite Financial Index (CFI) Scores for FY 2022



This graph shows that the overall pattern is one of stability. System procedure requires follow up if an institution's annual CFI score is less than 0.5. As was the case in fiscal year 2021, the system did not have any college or university below 0.5 for fiscal year 2022. In previous years one or two institutions had been below 0.5. Looking at numbers between 0.5 and 1.5, four institutions fall in this range. Between 1.5 and 3.0, there were six institutions this past year. And looking at institutions between 3.0 and 7.0, there were 23.

To take a slightly longer-term look at CFI, the system procedure also sets a trigger for two-year average CFI scores. Looking at the two-year average CFI numbers, we do see some improvement but as in the past, some institutions have triggered this measure for review. As Graph 9 shows, four institutions had two-year average CFI scores of less than 1.5, six fell into the 1.5 to 3.0 range, fourteen fell into the 3.0 to 5.0 range, and nine achieved the 5.0 to 7.0 range.

Graph 9. Two-year Average CFI Scores for FY 2022

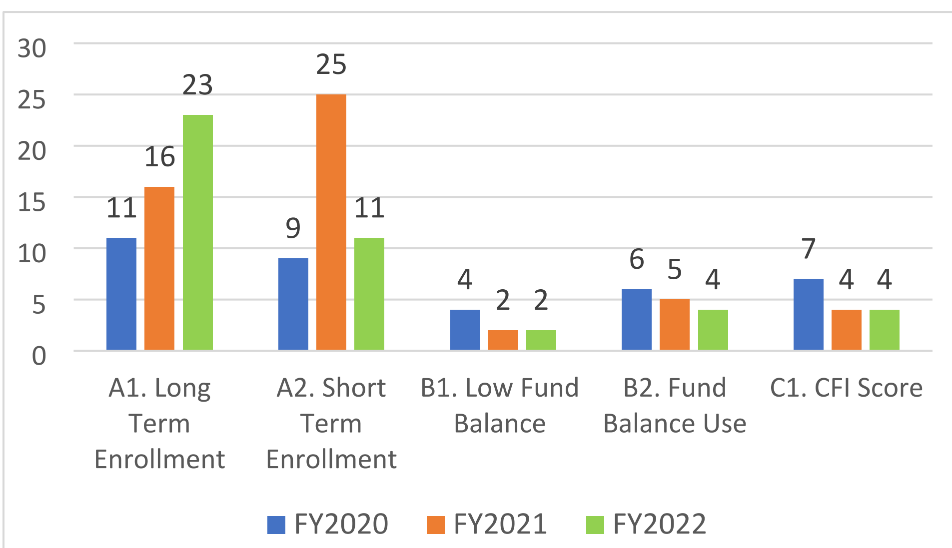


System procedure requires follow up if an institution's two-year moving average CFI score is less than 1.5. These results show improvement over recent years and indicate that the institutions have managed to the unique dynamics of the pandemic and leveraged HEERF funds in ways that maintain their financial health.

SUMMARY OF FINANCIAL HEALTH INDICATORS AND FOLLOW-UP ACTIONS

Graph 10 summarizes the number of institutions that have triggered each financial health measure for the past three fiscal years.

Graph 10. Summary of Financial Health Indicators FYs 2020, 2021, 2022



This graph shows again the significance of the enrollment concerns currently challenging colleges and universities. The enrollment changes institutions have faced recently are significantly greater than pre-pandemic trends, significantly challenging budget and other planning processes. Of the five measures, four colleges triggered none of them, fifteen colleges triggered one, six colleges triggered two, and one college triggered three. One university triggered no measures, three universities triggered one, one university triggered two, one university triggered three, and one university triggered four.

While the fund balance measures show more stability, the effect of federal HEERF dollars that have supported general fund activities masks the true nature of the challenges posed by reductions in revenues and increases in costs brought on by the pandemic and declining enrollments. A return to a more normal structural balance between sources and uses of fund will likely require substantially more time than the federal assistance will last. With the extension of the availability of federal HEERF dollars, fiscal year 2023 is proving to have many similarities to fiscal year 2022 for many institutions. Expectations for fiscal year 2024 are that additional efforts will be required to meet the financial challenges in declining enrollments.

For colleges and universities that triggered one of the enrollment measures, system procedure requires preparation of revised enrollment plans and budgets that incorporate the associated revenue losses. Those institutions that triggered the short-term enrollment indicator have already provided responses for these variances.

For colleges and universities that triggered one of the fund balance measures or the CFI measure, financial plans must be developed to identify the changes that will bring the institution back into a financial situation that will not trigger the measure. These plans are being prepared this month. Once plans are submitted, discussions will take place to include the presidents and members of their leadership teams, the vice chancellor for finance and facilities, and others. The board will be updated on budgets and related matters in the coming months.

REVIEW AND UPDATES TO SYSTEM PROCEDURE 7.3.16

System Procedure 7.3.16 on financial health indicators was last updated in August 2016. Since then, the work done with colleges and universities to respond to situations that triggered these measures has prompted the question of whether there could be improvements to the effectiveness of the measures. The effects of the pandemic have provided new experience with unique new stresses on revenues paired with the one-time funding assistance provided by federal HEERF dollars.

Over the past several months, the Finance Resource Allocation and Policy (FRAP) group performed a review of System Procedure 7.3.16. The FRAP group operates in an advisory capacity to the Finance and Facilities division. FRAP includes members from colleges and universities, large and small in size, with single and multiple campuses and campuses that are urban and more rural. Members come from academic and student affairs, institutional research, equity and inclusion, finance, and business offices. During the review of System Procedure 7.3.16, the FRAP group discussed the overall policy goals behind the procedure, the rationale and usefulness of each existing measure, ideas for changing existing measures or adding additional measures. Based on those discussions, the group made recommendations for updates to the procedure.

One of the main recommendations is to add measures specific to the Revenue Fund. The Revenue Fund exists separately from the General Fund for the campus facilities that have unique operations generating revenues expected to fund the costs of operating those facilities. This was not a new idea, but it did take on more importance during the pandemic, which caused significant reductions in the use of Revenue Fund facilities. Significant reductions in on-campus housing and dining facilities were especially prominent at universities. Both colleges and universities saw reductions in food service, parking facilities, and events and other ongoing activities that generated the revenues needed to run Revenue Fund facilities. While HEERF dollars provided support to backfill lost revenues at many institutions, ongoing enrollment declines and changes in the numbers of students and visitors to campus have been posing new challenges to Revenue Fund activities. Many colleges and universities have had to use fund balance to balance these budgets as HEERF funds were not adequate to fill the entire revenue gap. Operating budget updates provided to the board have separated out the Revenue Fund and have shown the effects of these changes at the system level. For example, the October budget update showed that Revenue Fund revenues were $17 million (almost 15 percent) less in fiscal year 2023 compared to fiscal year 2019.

Because residential housing makes up roughly 74 percent of Revenue Fund revenues, one recommendation is to add a measurement of occupancy in on-campus housing. As reported in the October budget update, bed utilization declined by 29 percent between fiscal year 2019 and fiscal year 2023. Adding this as a measure in system procedure would provide consistency and transparency to our colleges and universities tracking of this revenue variable going forward.

At a higher level, fund balance measures already calculated for the Revenue Fund as part of ongoing reporting to national credit rating agencies could also be monitored within the context of the system procedure. Since one significant use of Revenue Fund revenues is the payment of debt service on funds borrowed, it would be useful to monitor at each college and university the ability of operating surpluses to cover annual debt service on an ongoing basis.

Another recommendation was to somehow expand the measurement of fund balance health to include more specifically how it is used to balance ongoing general fund operating budgets. Looking at budget numbers is more forward-looking than looking at year-end numbers. While budgets are plans subject to change, the thinking is a budget-related measure could prompt earlier discussions of potential concerns and the plans to address them.

Additional recommendations included better alignment and clarity on reporting dates, data requirements and resolution parameters, and focusing resolution requirements more on strategic management than addressing specific current numbers.

Based on these recommendations, formal edits to the procedure are being prepared for public review. After any changes made as a result of the public review process, it is anticipated that the updated procedure will be used in the fiscal year 2023 financial health review.