College for all Texans

Texas Higher Education Coordinating Board

Financial Condition Analysis Of Texas Public Community College Districts

2014

Planning and Accountability

Texas Higher Education Coordinating Board

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, Senate Bill 1 (S.B. 1), 83rd Texas Legislature, Section 13 (page III-198). 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 $1.68 billion since fiscal year 2008. Most of the increase is due to the general obligation bonds issued by districts. For fiscal year 2013 the combined noncurrent obligations for public community colleges was $4.778 billion. Overall, the public community colleges are managing the growth they have experienced. This is reflected in the increase in net assets of $206 million in fiscal year 2013 over fiscal year 2012. Net assets have increased $1.391 billion since fiscal year 2008 to $5.531 billion in fiscal Year 2013. Expendable net assets for fiscal Year 2013 are $2.032 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. 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 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, including 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 itself 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 strength in another. Additionally, measuring the index over time provides a glimpse of 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 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 assets generated by operating revenue?" The 2013 statewide ratio for public

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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.

community colleges is .39, which is a slight decrease from .40 in 2012. A ratio of 0.14 or greater is the standard used in this report. The standard was met by 47 of the 50 districts.

Viability Ratio – measures the financial health of the institution by comparing total expendable net assets to certain noncurrent liabilities. The 2013 statewide ratio for public community colleges is 1.08, which is an increase from 1.03 in 2012. 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 2013 statewide ratio for public community colleges is 3.86 percent, which is a decrease from 7.10 percent in 2012. A positive return is the standard used in this report. The standard was met by 40 of the 50 districts.

Operating Margin – indicates an operating surplus or deficit in the given fiscal year. The 2013 statewide margin for public community colleges is 5.13 percent, which is a decrease from 7.32 percent in 2012. A positive margin is the standard used in this report. The standard was met by 39 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 2013 combined CFI for public community colleges is 3.06, which is a decrease from 3.63 in 2012. 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.

Equity Ratio – An equity ratio is a comparison of net assets to total assets and is used when institutions have no outstanding indebtedness. The 2013 statewide ratio for the public community colleges is 48.1 percent, which is a decrease from 49.5 percent in 2012. A ratio of 20 percent 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 2013 statewide ratio for the public community colleges is .32, which is a slight decrease from .33 in 2012. 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 contains the indicators for the 50 districts for fiscal year 2013. An Excel workbook is available that contains all of the financial data used for the indicators and includes data for fiscal years 2003 to 2013.

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-three of the 50 public community college districts have little or no indication of financial stress, which is a decrease of four institutions since fiscal year 2012. Thirty-one of the 43 districts meet the threshold for all indicators. They are adequately capitalized, adding positive net asset balances, and are properly positioned for future success. The remaining 14 do not meet the threshold for two or fewer indicators.

Seven institutions do not meet the threshold for three or more of the indicators. The number of institutions in this category has increased by four since fiscal year 2012. A discussion of these institutions follows.

- 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 $.867 million, which lowered the primary reserve to less than two percent. In four of the last six years the college has had a positive operating margin and return on net assets. The college has not met the 2.0 threshold on the CFI for the past two years.

- 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 four of the indicator thresholds. The return on net assets and operating margin were negative. Net assets fell $395 thousand, which lowered the primary reserve below the state standard of greater than 14 percent. In the previous three years, the college has had a negative operating margin and has not met the 2.0 threshold on the CFI.

- Laredo College did not meet four of the indicator thresholds. For fiscal year 2013, return on net assets was negative, and the institution's CFI slipped below the standard of 2.0. In the previous two years, the viability and leverage ratios have been below standard.

- Alvin College did not meet three of the indicator thresholds. The return on net assets and operating margin were negative. The college's primary reserve ratio decreased by .04 percent from fiscal year 2012, which resulted in the college falling just short of meeting the state standard of greater than 14 percent.

- Cisco College did not meet three of the indicator thresholds. The return on net assets and operating margin were negative. The CFI fell below the 2.0 threshold. The college met all of the leading indicators in fiscal year 2012.

- 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 out of six years, the college has had a positive operating margin, and return on net assets has been positive in four of the past 6 years. The CFI has been above the 2.0 threshold in four of the six previous years.

- Houston Community College had a material, internal control weakness, as identified by their external auditor. A single finding in the area of Title IV refunds and procedures, noted that a calculation error had occurred in the return of unearned funds to Title IV. This error resulted in the institution being obligated to return $550,287 to the U.S. Department of Education. The institution's management has concurred with the audit finding and has provided a detailed plan to ensure compliance in this area. The external auditor also reported a repeat finding from the previous year in the area of Pell disbursements. The corrective action for the Pell finding was implemented for the fall 2012 semester.

Conclusion

Significant improvements in the financial condition of public community colleges have occurred in fiscal year 2013 when compared to fiscal years 2010 and 2011. However, in fiscal year 2013 six institutions exhibited further decline in their financial condition when compared to fiscal year 2012.

	FY 2013	FY 2012	FY 2011	FY 2010
Met all 7 indicators	31	39	33	22
Met 6 indicators	5	6	8	10
Met 5 indicators	7	1	4	6
Met 4 indicators	3	2	2	7
Met 3 indicators	2	1	1	5
Met 2 indicators	2	1	2	0
Statewide CFI	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. 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: Feedback Received from the Institutions

<u>Keith Blundell; V.P. Administrative Services; Victoria College</u>

"Per the THECB's Financial Condition Analysis of Texas Public Community College Districts for 2013, if a Texas community college fails to meet the required threshold in two or more of the nine index/ratios, the institution is deemed to show some indication of financial stress. In the event a college fails in 2-3 of the index/ratios, the institution is given a stress indicator of yellow or warning. Victoria College has not met the standard for the same three index/ratios for the last two consecutive years. The indicators not met are the Composite Financial Index, Return on Net Assets and Operating Margin. The Return on Net Assets and the Operating Margin both depend upon positive margins. The Composite Financial Index measures the strength of four ratios, which include the Return on Net Assets and Operating Margin. Therefore, when these two indicators are negative, the Composite Financial Index will be greatly impacted/reduced.

For the fiscal years ended August 31, 2012 and 2013, Victoria College's board of trustees purposely budgeted some operating expenditures out of the college's net position. In 2012, $1,552,883 was budgeted as an operating expense and a transfer from net assets. In 2013, $831,200 was budgeted in the same manner. Had these transactions not occurred, the Return on Net Assets and Operating Margin would have been positive which, in turn, would have resulted in a healthy Composite Financial Index. With these transactions, the college's equity based ratios did not suffer, which indicates that the net position of the institution is still sufficient for operations."

<u>Beatriz T. Espinoza, Ph.D., President, Coastal Bend College</u>

"Coastal Bend College (CBC) continued the transition of realigning budgets, staff, processes, and operating efficiencies through FY 2013. Even though our indicators are low, they have showed significant improvement from FY 2012. The Board of trustees and the administration has addressed the problem and are committed to stabilizing the college's financial situation. Although CBC showed a decrease in assets of $866,673 in FY 2013, last year in FY 2012 our decrease was $2,083,475. In FY 2013 CBC continued the implementation of stricter spending controls. The board and administration have budgeted and committed to setting aside a contingency line item in FY 2014 for $1.5 million in order to build up the reserves back to a $5.5 million over 3 years (FY2013-FY2015). Significant progress is being made and CBC is on track to establishing long-term financial stability.

In summary, Coastal Bend College is working diligently to provide student success, and efficiently use resources to benefit our students. We continue to be good stewards of student and taxpayer dollars."

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

Fiscal Year **2013**
General Obligation Bond Debt **Excluded**

District	Composite Financial Index	Return on Net Assets	Operating Margin	Primary Reserve	Viability Ratio	Equity Ratio	Leverage Ratio
Alamo	2.09	3.17%	3.89%	0.30	0.52	30.3%	0.77
Alvin	2.67	**-9.01%**	**-5.13%**	**0.14**	24.31	46.6%	-
Amarillo	3.96	**-3.09%**	**-2.06%**	0.40	6.15	51.2%	0.04
Angelina	4.73	3.09%	**-0.10%**	0.36	15.35	58.4%	0.01
Austin	**(0.16)**	**-11.08%**	1.00%	0.15	**0.12**	**13.3%**	**4.48**
Blinn	2.29	4.70%	6.01%	0.20	0.53	55.4%	0.38
Brazosport	**1.95**	8.00%	**-0.45%**	0.17	0.90	33.4%	0.19
Central Texas	7.02	3.53%	6.29%	0.86	88.94	86.1%	-
Cisco	**0.37**	**-6.34%**	**-0.27%**	0.23	0.51	46.1%	0.71
Clarendon	**2.00**	**-0.51%**	1.19%	0.44	0.86	69.5%	0.08
Coastal Bend	**(1.05)**	**-8.27%**	**-2.56%**	**0.02**	**0.07**	35.7%	0.77
College Of The Mainland	5.17	3.68%	2.31%	0.37	9.73	75.5%	-
Collin	8.51	5.10%	10.99%	1.50	45.62	86.7%	0.01
Dallas	6.15	4.61%	8.10%	0.45	5.94	49.0%	0.06
Del Mar	4.82	11.39%	6.59%	0.48	1.75	46.7%	0.19
El Paso	2.91	5.83%	5.57%	0.30	0.88	52.8%	0.41
Frank Phillips	**0.08**	**-2.63%**	**-2.72%**	**0.12**	0.51	76.2%	0.17
Galveston	6.07	4.36%	5.54%	0.51	11.30	86.7%	0.02
Grayson	5.10	8.27%	2.79%	0.72	2.35	45.7%	0.25
Hill	6.44	7.74%	8.67%	0.44	4.18	76.9%	0.08
Houston	2.12	2.15%	10.14%	0.27	**0.23**	22.6%	1.41
Howard	2.42	6.10%	1.60%	0.33	0.84	52.9%	0.33
Kilgore	5.95	3.98%	4.98%	0.51	11.31	90.7%	0.02
Laredo	**1.66**	**-0.52%**	4.08%	0.34	**0.27**	20.5%	**2.35**
Lee	**1.08**	0.29%	**-0.37%**	0.23	0.58	35.9%	0.26
Lone Star	**1.25**	1.28%	**-2.38%**	0.24	1.00	28.7%	0.32
Mclennan	2.28	6.59%	3.65%	0.18	0.75	32.7%	0.34
Midland	3.72	3.99%	3.95%	0.45	1.87	63.0%	0.13
Navarro	2.81	8.17%	6.87%	0.23	0.48	46.5%	0.55
North Central Texas	6.19	10.50%	9.13%	0.49	3.39	78.7%	0.15
Northeast Texas	**1.34**	4.44%	0.12%	0.18	0.48	36.9%	0.48
Odessa	4.79	10.45%	17.40%	0.62	1.33	29.9%	0.45
Panola	6.43	9.73%	10.05%	0.59	3.47	73.3%	0.14
Paris	3.56	5.38%	8.05%	0.48	0.90	60.6%	0.45
Ranger	5.65	28.88%	13.52%	0.50	1.59	48.7%	0.49
San Jacinto	4.27	2.01%	**-5.93%**	0.37	13.43	37.9%	0.02
South Plains	2.62	3.16%	3.83%	0.21	1.43	75.0%	0.17
South Texas	7.96	7.77%	10.84%	1.02	2,371.23	81.5%	-
Southwest Texas	**1.88**	**-0.90%**	2.05%	0.39	0.78	40.1%	1.00
Tarrant	5.66	4.22%	8.47%	0.28	14.30	92.6%	-
Temple	3.97	5.67%	4.82%	0.53	1.56	40.8%	0.32
Texarkana	2.19	4.30%	3.63%	0.14	1.04	73.0%	-
Texas Southmost	5.39	5.80%	7.58%	0.87	1.81	50.8%	0.22
Trinity Valley	4.68	2.29%	2.76%	0.21	12.73	91.9%	0.01
Tyler	2.10	4.43%	8.35%	0.16	**0.27**	46.9%	0.51
Vernon	**1.34**	0.86%	2.60%	0.20	**0.41**	48.1%	0.63
Victoria	**1.60**	**-2.23%**	**-3.73%**	0.59	0.81	44.9%	0.86
Weatherford	4.17	1.10%	0.98%	0.77	2.27	64.9%	0.26
Western Texas	3.61	14.81%	11.20%	0.26	0.53	56.1%	0.46
Wharton	6.04	5.00%	5.40%	0.48	6.64	76.3%	0.06
Statewide	3.06	3.86%	5.13%	0.39	1.08	48.1%	0.32

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

Planning & Accountability
P.O. Box 12788
Austin, TX 78752
512/427-6153

Susan E. Brown
Assistant Commissioner
Susan.brown@thecb.state.tx.us

Gary W. Johnstone
Deputy Assistant Commissioner
gary.johnstone@thecb.state.tx.us