

**BOARD OF TRUSTEES
MINNESOTA STATE COLLEGES AND UNIVERSITIES
*INFORMATION ITEM***

Fiscal Year 2004 Audited Financial Statements

BACKGROUND

The purpose of this Board report is to present to the Audit committee of the Board of Trustees the audited financial report for the Minnesota State Colleges and Universities for the year ending June 30th 2004 and 2003. The financial statements were prepared by the Finance division of the Office of the Chancellor with the assistance of the campus Finance departments and have been audited by the firm of Kern, DeWenter, Viere, Ltd. This is the first year of a three year contract with Kern, DeWenter, Viere, Ltd. as the system auditor.

The separately prepared and separately audited financial statements for the FY2004 activity of the Revenue Fund and the following schools will also be presented at this meeting:

Audited by Kern, DeWenter, Viere, Ltd –

1. Bemidji State University
2. Minnesota State University Moorhead
3. Northwest Technical College
4. Southwest Minnesota State University
5. Rochester Community and Technical College

Audited by Larson, Allen, Weishair & Co, LLP -

6. Minnesota State University Mankato
7. Saint Cloud State University
8. Winona State University
9. Century College

Audited by Virchow, Krause and Company, LLP -

10. Metropolitan State University
11. Minneapolis Community and Technical College
12. Hennepin Technical College

In addition, the firm of Kern, DeWenter, Viere, Ltd was engaged to perform Limited Scope Reviews for Fergus Falls Community College and Northland Community College. The work is preparatory to establishment of opening balances for FY2005 which is the first fiscal year of operations for Minnesota State Community and Technical College,

Northland Community College at Thief River Falls and East Grand Forks and Bemidji State University - Bemidji Technical College.

AUDIT RESULTS

The system wide audit is the fourth system wide audit prepared since the merger of the three former systems of higher education. The system wide, revenue fund and the twelve individual audits once again received unqualified opinion letters from the auditors. The opinion letters provide the Board and other users of the financial statements with assurance that the information is materially accurate and reliable. There were also no material internal control weaknesses identified in any of the audits. The external auditors will present these conclusions, along with required communications to the Audit committee at the December meeting. The auditors will also present information on prior period adjustments necessary in all of the colleges and universities to correct a prior allocation of capital appropriation funds. Kern, DeWenter, Viere, Ltd, the system wide auditor, issued management letters for both the system wide and revenue fund statements. Management agrees with and will take the necessary steps to respond to the observations made in the management letters.

The information in the Revenue Fund and twelve individual financial statements has been incorporated into the system wide financial information. Consequently, the balance of this report will present a discussion of the system wide financial statements only. All of the auditors will be in attendance at the Audit committee meeting and will present the results of their work.

PRESENTATION

The FY2004 and FY2003 financial report is presented in accordance with Statement No. 35 *Basic Financial Statements – and Management’s Discussion and Analysis – for Public Colleges and Universities* as established by the Governmental Accounting Standards Board (GASB). The system’s financial information is presented in one column form as a “Business Type Activity”. The resources are still governed by the governmental fund based principles and continue to be accounted for in the general, special revenue, enterprise, and revenue funds. Fund level information can be found in the financial statement supplemental schedules.

Effective with the FY2004 financial report, all university related foundations are also included in both the related university financial report and the system financial report. Reporting standards require the inclusion of related entities if found to be “material” to the primary organization. The university foundations and their auditors have been very cooperative in alteration of their audit schedules in order to conform to the schedule for the system financial report.

The FY2004 and FY2003 Financial Report includes system level information only. A separate supplemental document contains the corresponding information for each college and university.

Consolidated Statement of Net Assets

The system's overall financial condition, as measured by an increase in net assets, improved slightly between FY2003 and FY2004 due to increased investment in capital assets by the legislature and the colleges and universities.

Total assets increased 8% over FY2003 due to both increase in cash and cash investments and substantial capital asset increases. Fiscal year 2004 capital outlays, including donated capital assets, totaled \$164 million and included \$119 million of construction in progress. Total liabilities at year end increased \$61 million or 13% finishing the year at \$534 million vs \$473 million at the end of FY2003.

Consolidated Statement of Revenues, Expenses and Changes in Net Assets

While net assets increased, the system's operating performance held steady at virtually the same levels as FY2003:

- Lost state support was replaced with tuition and other charges
- Operating expenses declined in order to balance the revenue changes

Salaries and compensation costs increased \$26 million or 2.9% compared to FY2003 while all other expenses declined \$33 million for a net operating cost decrease of \$7 million. Minor changes in other revenues resulted in an operating loss of \$5 million, a \$20 million improvement from the \$25 million loss reported in FY2003.

Summary ratios for FY2004, FY2003 and FY2002

The National Association of College and University Business Officers published suggested financial statement ratios that incorporate the impacts of the change in financial statement presentation. The ratios are designed to illustrate trends in financial performance over a period of years; they are intended to address financial sufficiency and flexibility as of the balance sheet date and compared to a year ago. These ratios were first introduced to the Board of Trustees last year. As the Minnesota State Colleges and Universities add successive years of audited statements, trend analysis will become more robust.

The suggested ratios have been prepared using fiscal year 2003 and 2004 performance based upon the consolidated statements for all activity. The information shown in the ratios included the activity of the general, special revenue, enterprise and revenue funds at all colleges and universities and in system accounts.

Because the information is drawn from the consolidated statements, the ratios do not illustrate the performance of individual colleges and universities. The supplemental schedules contained in the Board material should be examined to learn about each school's individual performance.

Efforts have been made to identify and include information concerning performance by similar systems across the nation. This effort will be more fruitful in the future as more and more systems publish trend data according to the new reporting standards. Shown

below are the system ratios for FY2004 – 2002 along with FY2003 and FY2002 performance published by Moody’s Investor Services for 159 public higher education institutions nationwide (“National median”).

Moody’s has conformed the population of institutions used in FY2002 to match the available FY2003 population, which has caused the median values for FY2002 to change, but not materially, from the values presented to the Board in last year’s report. The national data population includes Research I institutions and so is not strictly comparable in all respects to the system. Moody’s median data is provided here for general comparative purposes. Appendix A includes additional, secondary ratios.

Ratios from Consolidated Statements of Revenues, Expenses and Changes in Net Assets and Consolidated Statements of Net Assets

	FY2004	FY2003	FY2002
System primary reserve ratio	17%	17%	15%
National median		39%	39%

The primary reserve ratio measures the organization’s capacity to operate without generating new assets; the percent of total annual operating expenses that could be financed using reserves. This measure is a cousin of the Board’s “budget reserve” ratio. A steady primary reserve ratio indicates that expendable (restricted and unrestricted) net assets have increased from one year to the next at the same pace as expenses. The FY2004 system primary reserve level equates to two months of operating expenses.

	FY2004	FY2003	FY2002
System net income ratio	4%	5%	8%
National median			n/a

The net income ratio measures whether an organization is operating with a surplus or deficit by comparing the change in total net assets to total revenues. Moody’s does not compute median values for this measure. This ratio is influenced by the system’s pattern of construction completion and the state’s subsidy of the system’s debt service. This happens because the portion of system bond receipts retained as debt by the state is recognized as capital appropriation income by the system. Regarding FY2004 performance, a decreasing net income ratio, in combination with a steady primary reserve ratio, indicates that while net assets have increased, the increase was almost entirely used to increase capital assets (not considered to be “expendable net assets” in computing the primary reserve ratio above).

	FY2004	FY2003	FY2002
System annual operating margin	-0.4%	-1.9%	1.7%
National median		1.0%	1.3%

The annual operating margin above is somewhat similar to the “net income ratio,” but it excludes all revenue deemed to be unavailable to cover operating expenses (excluded

from both the numerator and denominator). For the system, the revenue sources excluded are capital appropriations (used for capital assets), donated capital assets and insurance proceeds realized due to the fire in 2002 at Southwest Minnesota State University.

For example, the system's FY2003 -1.9% margin above excludes \$86 million of capital appropriation, \$11 million of insurance proceeds and \$2 million of donated capital assets. Consideration of the annual operating margin allows comparison with the 5% net income ratio. While the system's margin slipped into negative territory in 2003, the combination of increased tuition revenue and very tight cost controls nearly eliminated the negative margin in 2004.

	FY2004	FY2003	FY2002
System viability ratio	118%	129%	125%
National median		105%	124%

The viability ratio measures the capacity for expendable net assets to cover all outstanding debt should liquidation of the organization occur as of the date of the financial statements. While considered a basic ratio of financial health, it is less applicable here due to the system's affiliation with state government and the state's contribution to the system's debt costs. If all system related general obligation debt were included, this percentage would shrink. For example, if the state had not retained two-thirds of the system's general obligation bond debt, the system's debt balance would be approximately \$270 million greater as of June 30, 2004 resulting in a viability ratio of 50%.

	FY2004	FY2003	FY2002
Board reserve ratio - colleges and universities	4.2%	3.7%	4.3%

The primary reserve ratio compares all expendable net assets to operating expenses while the Board reserve ratio compares general fund operating revenues to that portion of expendable net assets held in a special reserve account. The primary reserve ratio is substantially higher than the Board reserve ratio since the former measures all expendable net assets as a percentage of operating expenses for the operation as a whole and the latter measures the special reserve account amount as a percentage of general fund revenue.

The system's overall ratios are the result of the performance of each of the colleges and universities. The supplemental statements provided separately from the financial statements have been examined at the institutional level and additional ratio detail is provided below. Information concerning 36 colleges/universities is reported as a result of the re-configuration underway in the northwest and the separate reporting for the northeast colleges.

Selected ratios of institutional performance

The ratios reviewed above can also be examined at the individual college/university level. All colleges and universities were divided into three groups of equal number based upon the performance against each ratio and an average computed for each group. Schools are in different tiers depending upon the ratio under discussion.

	Primary Reserve Ratio		Net Income Ratio		Viability Ratio	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Lower third	3.6%	4.7%	-4.7%	2.1%	36.2%	45%
Middle third	12.8%	12.6%	0.9%	4.5%	97.1%	108.9%
Upper third	22.4%	27.5%	9.7%	14.4%	242.9%	270.5%
System	16.9%	17.0%	4.4%	5%	118.4%	129%

The above three ratios, viewed in concert, illustrate a broad dispersion of financial conditions when individual colleges and universities are examined. Annual performance measured by the net income ratio, tracks well with the primary reserve ratio and the viability ratio. Institutions with low net income also have low reserves and less capacity to liquidate all obligations. The ratios presented for both the three groupings and systemwide show some deterioration between 2003 and 2004. This stems primarily from the lower levels of net income which in turn negatively impact expendable net asset growth.

	FY2004		FY2003		FY2002	
	<u>#</u>	<u>%</u>	<u>#</u>	<u>%</u>	<u>#</u>	<u>%</u>
Operating loss*	27	75%	19	53%	15	42%
Negative unrestricted net assets	3	8%	5	14%	8	22%
Board reserves below 3%	4	11%	7	19%	5	14%

* As shown in financial statements on line titled "Income (loss) before other revenues, expenses, gains, or losses"

A reported operating loss is not necessarily a negative indicator. It could be the result of a continuing imbalance between revenues and expenditures or a one-time expenditure which relied upon balances or other revenue; however, the fact that the percentage of schools with an operating loss increased from 53 % in 2003 to 75% in 2004 is potentially an indicator that a revenues and expenditures imbalance trend is developing. It is an event to be analyzed and understood, particularly as to implications for future years. Negative unrestricted net assets indicate that current and long term liabilities exceed non-capital assets. Institutions in this position are generally in a deficit budget position on an accrued basis. The Office of the Chancellor will continue working with these institutions in the coming months to assist them in development of budget plans which build assets sufficient to cover long term liabilities. Board reserves reported at less than 3% are similarly an indicator of negative financial condition. Generally, institutions with negative unrestricted net assets do not have operating reserves although they may report Board reserves.

The trend in individual institutional performance between FY2003 and FY2004 is neutral to slightly negative. Operating losses increased while Board reserves increased slightly. It should again be noted that colleges and universities held the line on expenses as evidenced by the overall decrease in operating expenses after excluding compensation expense. Many schools spent reserves to cover operations as evidenced by reductions in many schools' unrestricted net assets between fiscal 2003 and 2004. The decline in the number of negative unrestricted net assets is largely due to cost cutting measures at the applicable schools.

CONCLUSION

The Minnesota State Colleges and Universities ended the year in stable financial condition. The current economic condition of the state as well as the national economy is a concern in the coming years. The chancellor and the presidents are dedicated to every effort to continue the Board's commitment to access, quality and affordability for current and future students. The information presented in this report is worthy of extended discussion. Staff would welcome the opportunity to discuss the report and answer any questions.

APPENDIX A

Secondary Ratios

	FY2004	FY2003	FY2002
System scholarship allowance	15%	14%	14%
National median		33%	34%

The above ratio measures the amount of tuition and fees that are financed by financial aid grant programs, primarily federally supported. The ratio also captures private grant programs, which are minimal for the Minnesota State Colleges and Universities. This ratio does not capture the recent reductions in state supported work study and child care resources.

	FY2004	FY2003	FY2002
System equity ratio	67%	68%	67%
National median			n/a

The above ratio measures resources financed by accumulated assets. This ratio is positively influenced by the state's contribution to the debt issued for the system's capital assets and negatively influenced by the amount of depreciation present in our physical plant.

	FY2004	FY2003	FY2002
System salaries and benefits as % of total expenses	67%	64 %	65 %

The above ratio measures commitment of the system's resources to personnel costs. It illustrates both the commitment to human resources as well as the investment rate in other parts of the operation such as materials, equipment, facility maintenance and technology. While salaries and benefits increased \$26 million (2.9%) all other expenses decreased by a net of \$33 million for a net \$7 million decrease in total expenses. This combination of a small increase in salaries and benefits and an overall decrease in total expenses drove the increase in salaries and benefits as a percentage of total expenses.

	FY2004	FY2003	FY2002
System Net Tuition and fee revenue as % of total revenue	31.3%	28.0%	25.8%
National median		15.7%	18.1%

This ratio measures the system's reliance on one source of revenue. Net tuition and fee revenue increased \$44 million while state appropriation declined \$32 million. Overall, the system's total revenue decreased \$14 million from FY2003 to FY2004.