TOPIC:
Financial Performance Goals

CONTEXT:
As part of the FY 2007 budget process, the Fiscal Affairs Committee and the University Administration agreed to review the University Financial and Planning Operations Guidelines that were approved by the Board in May 1997.

RECOMMENDATIONS:
The attached document makes specific recommendations in three key areas. These are:

- Liquidity
- Margin
- Debt Coverage

The attached document also addresses the following important issues:

- Credit Rating
- Financial Targets for the Health System
- SB6 Ratios
- Other Reserves

CONSIDERATIONS:

- Are the goals clear and appropriate?
- How do they compare with benchmark and best practices?
- Have the external auditors and rating agencies been consulted?
- Who has been consulted internally?
- How does this integrate with other policies (e.g., long-term operating fund)?
- Does this strike the appropriate balance between financial stability and programmatic support?
- How do reserves for maintenance and renewal fit in?

REQUESTED OF FISCAL AFFAIRS COMMITTEE:
First reading only. For discussion and advice.
As part of the FY 2007 budget process, the Fiscal Affairs Committee and I agreed to review the University Financial Goals and Measures originally approved in May 1997. My staff has been collecting and analyzing relevant data for over a year. We have now agreed on a set of measures we are prepared to recommend to the President's Cabinet and the Board of Trustees.

For your reference, a copy of the 1997 financial measures and goals are included as Attachment A. What we have tried to do is both think strategically and take into account the changes at the University and in our environment since that time. For example:

- Total revenues have grown from $1.5 Billion in FY 1997 to $3.7 Billion in FY 2007.
- The state funded share of the budget has declined from 19.9% to 9.9%.
- The Health System's share of the budget has grown from 25% to 37% (including OSUP).
- The gifted endowment has grown from $833 Million to $1,574 Million.
- Bonded indebtedness has grown from $176.2 Million to $1,061 Million.
- The University's credit rating has remained stable at AA.
- The University's academic reputation has risen.
- The events of September 11, 2001 demonstrated the potential disruption of key economic institutions by terrorist attacks.
- Hurricane Katrina (2005) showed the vulnerability of both public and private institutions to financial disruptions due to natural disasters.

The goal of this process is to update the Measures of Financial Progress so that resources continue to be available to accomplish the University's academic goals on a sustained basis.
Measures of Financial Progress

Measures of a public sector and not for profit organization’s financial strength commonly consist of three components:

1. Resource Efficiency and Flexibility (Liquidity) – maintaining a sufficient level of expendable reserves, relative to the size of the organization.
2. Annual Operating Margin – spending less than is taken in on an annual basis.
3. Debt Coverage – sufficient resources on hand to cover existing and anticipated debt.

Resource Sufficiency and Flexibility Recommendations

A key measure of an institution’s resource sufficiency and flexibility is the Primary Reserve Ratio (PRR). The PRR is a measure of the University's ability to sustain itself, even if income is interrupted. The PRR for public institutions is defined as the expendable net assets compared to total expenses for a year, which reflects the sufficiency of resources and the flexibility of net assets. An analysis of higher education financial statements indicates that a generally healthy institution should have a PRR of 0.4, which equates to approximately 5 months or 146 days cash-on-hand (Strategic Financial Analysis in Higher Education, Sixth Edition, page 58; Prager, Sealy and Co, LLC; KPMG, LLP; Bearing Point, Inc., 2005).

The PRR is comparable to Moody’s Expendable Financial Resources-to-Operations which provides data for comparable benchmarks. Below are OSU’s PRR compared with Moody's Public Institution Rating Levels for 2006:

<table>
<thead>
<tr>
<th>Moody’s 2006</th>
<th>OSU</th>
<th>AAA/AA1</th>
<th>AA2</th>
<th>AA3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expendable Financial Resources-to-Operations (x)</td>
<td>0.41</td>
<td>1.01</td>
<td>0.69</td>
<td>0.47</td>
</tr>
</tbody>
</table>

It is recommended that OSU’s minimum target for PRR be 0.40. OSU’s PRR for 2006 is a minimum of 0.41 which equates to 150 days cash-on-hand.

PRR is calculated based on audited financial statements and takes into account accrual entries and includes the President’s Strategic Investment Fund, Health System investments in subsidiaries, OSU Foundation Deferred Gift.
investments, Medical Malpractice cash and investments, and other affiliated entities cash and investments.

To ensure we sustain a strong PRR, it is recommended that the University maintain its current Rainy Day Fund level of at least 1% of annual general fund expenses. The Office of Business and Finance is analyzing the status of specific reserves currently in place to address specific high risk activities to determine if an overall reserve should be established, rather than purpose specific reserves. Our current specific reserve targets are included as Attachment B.

In addition, we recommend efforts continue to increase the size of the gifted endowment and the Long-Term Investment Pool where feasible.

**Operating Margin Target Recommendations**

Operating margin represents the difference between annual resources acquired and annual resources expended. Like a private, profit making organization, a negative operating margin is bad. Unlike a private, profit making enterprise, high margins are not necessarily a good thing for a non-profit organization because it means the organization is just sitting on money instead of putting it to the use for which it was intended.

Ohio State has a mixture of activities and programs. It includes academic operations whose activities are much like a traditional not for profit, as well as auxiliaries, such as the Health System, whose operations are more like organizations in the for profit sector. The recommendation is to establish at least two operating margin targets that reflect these differences.

For general funds, the recommendation is a margin of at least 1%. For the Health System, which faces higher risks of revenues swinging dramatically lower in a short period of time, a larger margin of 10% to 11.5% has been established by the Health System and is recommended as appropriate. (The Health System Operating Margin is supported by the financial statements of the Health System. The EBITDA margin stands for Earnings Before Interest, Tax, Depreciation and Amortization.)
The Office of Business and Finance is reviewing the establishment of operating margin targets for the other auxiliary and restricted fund groups, as well as recommendations for reserves for capital, including maintenance and renewal.

Credit Rating/Debt Management Recommendation

The University's credit rating is an important measure of financial well being for two reasons. First, it is a good measure of how much debt the University can issue without jeopardizing its financial health; and second, it is a good measure of financial conditions as determined by a knowledgeable and disinterested third party.

The 1997 Financial Guidelines include a commitment to maintain a credit rating of AA or better – this is the University's current rating.

In 2006, the OSU Board also asked the University Treasurer to highlight the three most important financial ratios that affect the University's credit rating. These are listed below, along with the FY 2006 medians for the top three rating categories and OSU's results for that year.

<table>
<thead>
<tr>
<th>Ratio</th>
<th>OSU</th>
<th>AAA/AA1</th>
<th>AA2</th>
<th>AA3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Financial Resources to Direct Debt</td>
<td>2.3 x</td>
<td>3.9 x</td>
<td>2.7 x</td>
<td>1.8 x</td>
</tr>
<tr>
<td>Actual Debt Service to Operations</td>
<td>2.4%</td>
<td>4.1%</td>
<td>2.6%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Debt Service Coverage</td>
<td>5.7 x</td>
<td>2.8 x</td>
<td>3.9 x</td>
<td>3.0 x</td>
</tr>
</tbody>
</table>

As the chart shows, OSU outperforms the AAA/AA1 targets in two of the three measures, but falls below significantly in total financial resources to direct debt. This primarily reflects our relatively small endowment when compared to the AAA/AA1 rated institutions.
It is important to remember that financial ratios constitute only a portion of a rating agency's assessment. The management of the institution and the relative financial condition of the state government are also important. For example, the University of Michigan (which reports a $5 billion + endowment) is the only public university to maintain a credit rating higher than its state government.

In order to maintain a credit rating of at least AA, the following targets are recommended regarding the three financial ratios described above:

<table>
<thead>
<tr>
<th>Financial Ratio</th>
<th>Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Financial Resources to Direct Debt</td>
<td>At least 2.0 x</td>
</tr>
<tr>
<td>Actual Debt Service to Operations</td>
<td>No greater than 4.0%</td>
</tr>
<tr>
<td>Debt Service Coverage</td>
<td>At least 3.0 x</td>
</tr>
</tbody>
</table>

**Senate Bill 6 Ratio Recommendation**

In addition to the rating agencies, the State of Ohio has developed a template to evaluate financial strength. This was developed in response to the struggles at Central State University in the early 1990s and is designed to give state officials an early warning of fiscal stress at its public universities. The factors included in this template are:

<table>
<thead>
<tr>
<th>Factor</th>
<th>Weight in Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Reserve Ratio</td>
<td>50%</td>
</tr>
<tr>
<td>Viability Ratio</td>
<td>30%</td>
</tr>
<tr>
<td>Net Income Ratio</td>
<td>20%</td>
</tr>
</tbody>
</table>

Since 1997, the State of Ohio has monitored the overall health of all state-assisted, higher education institutions through a scoring structure referred to as the Senate Bill 6 ratio. The Senate Bill 6 ratio provides a good foundation for monitoring our financial strength, particularly the aspect of resource efficiency and flexibility.

My staff and I recommend we continue providing the Board of Trustees with a review of the Senate Bill 6 calculations, specifically highlighting the Primary Reserve Ratio. In addition, we recommendation maintaining:
• operating margin targets that can be benchmarked overtime and with other comparable institutions, and

• the three debt ratios currently used:
  
  ➢ total financial resources to direct debt
  ➢ actual debt service to operations
  ➢ debt service coverage

The state guidelines call for a minimum ratio of 1.8 out of 5.0 as the threshold for financial watch. It is recommended that Ohio State establish a minimum goal of two times that amount or 3.6 out of 5.0. OSU concluded the most recent fiscal year (2006) with a ratio of 4.2.

**Conclusion**

Based on the changing environment of higher education financing and the need to update the financial benchmarks on which we monitor the financial health of the University, the following summarizes the recommendations set forth in this document:

1. It is recommended that OSU’s target for PRR be at least 0.40. OSU’s actual PRR for 2006 is 0.41 which equates to 150 days cash-on-hand. To ensure we sustain a strong PRR, it is recommended that the University maintain its current Rainy Day Fund level of at least 1% of annual general fund expenses.

2. For general funds, the recommendation is the operating margin should be maintained at at least 1%. For the Health System, which faces higher risks of revenues swinging dramatically lower in a short period of time, a larger margin has been established by the Health System and is recommended as appropriate.

3. The University should continue to track three key financial debt-related targets:
  
  ➢ total financial resources to direct debt
  ➢ actual debt service to operations
  ➢ debt service coverage
4. We should continue to provide the Board with a review of the Senate Bill 6 calculations and specifically highlight the Primary Reserve Ratio (PRR). In relation to the Senate Bill 6 requirement that calls for a minimum ratio of 1.8 out of 5.0 as the threshold for financial watch, it is recommended that Ohio State establish a minimum goal of two times that amount or 3.6 out of 5.0.

A comparison of the proposed 2007 guidelines with the 1997 version is included as Attachment C.

If you would like any additional information, please feel free to contact me.

Attachments

c: Leslie Flesch
   Tom Johnson
   Kevin Patton
   Greta Russell
   Mike Sherman
   Lee Walker
UNIVERSITY FINANCIAL PLANNING AND OPERATIONS GUIDELINES

WHEREAS a set of core principles is essential for sound financial management of a large organization; and

WHEREAS the attached set of principles has been developed by the Office of Finance and discussed throughout the University:

NOW THEREFORE

BE IT RESOLVED, That these principles be adopted by formal resolution of The Ohio State University Board of Trustees; and

BE IT FURTHER RESOLVED, That the Secretary be instructed to incorporate all supporting documents into the minutes of this meeting, and to file these materials with the official records of the university.
Financial Performance Objectives

NARRATIVE

In response to a request from the Fiscal Affairs and Investments Committee of the OSU Board of Trustees, the Office of Finance has developed a set of Financial Performance Objectives to guide the University's financial planning. These operating standards will also be beneficial in the University's dealings with the rating agencies and the Board of Regents. The rationale behind each of these measures is described in the remainder of this document.

GENERAL FUND RESERVES

Having appropriate reserves is critical to maintaining financial stability and to having resources sufficient to support the University's mission. The elements of an appropriate policy on reserves are as follows:

• The University General Funds budget should be balanced within a positive margin of 1% - Projecting revenues and enrollment is not an exact science. However, it is reasonable to expect a level of accuracy within 1%. Budgeting within a 1% margin means:

  1. Minor fluctuations will not necessitate continuing budget cuts.
  2. If projections are met, $4-5 million in cash will be made available annually to deal with budget needs not requiring continuing funds.

• The University will seek to maintain an unrestricted, uncommitted General Fund balance of roughly 5% of annual General Fund revenues - Budgeting to within a margin of 1% will address annual needs in a normal year, but will not provide much protection against an unexpected financial problem such as a large budget reduction or environmental catastrophe. For this purpose, a Rainy Day Fund or Unrestricted Fund balance is appropriate. Five percent (5%) is not an inappropriate amount for this purpose. With a $600 million General Fund budget this would total $30 million. This is not immediately achievable (the current balance is $7.5 million), but should remain as a goal. For example, $7.5 million would allow the University to delay a 2% state budget reduction for one year or a 4% reduction for 6 months.

• If the University gains an unexpected revenue windfall during the years, at least one half the amount should be put into reserve and no continuing funds should be allocated outside of the annual budget process - This policy provides a means for increasing the Rainy Day Fund. Requiring continuing funds to be allocated as part of the budget process codifies existing practice. This provides an opportunity to properly evaluate all spending proposals and to weigh them against other needs.
• MULTIYEAR COMMITMENTS

The ability to make multiyear commitments is essential to the University's ability to accomplish its mission. But these multiyear commitments must be carefully evaluated and weighed against future resources in order to prevent the loss of future financial flexibility. In order to accomplish these goals, the following policies should be implemented:

• The annual budget document will include an accounting of multiyear commitments and sources of funding - this is current policy and has been since the FY 1996 budget.

• Wherever possible, the funding sources for multiyear commitments will be identified and reserved at the time the commitment is made - this has also been informal policy beginning in FY 1996. For example, resources were identified at the time the Campus Partners initiative was approved in December 1995.

• Unfunded multiyear commitments should not exceed 1% of annual revenues - this policy is necessary to protect future flexibility, particularly in the General Fund. The University has been working towards this goal since FY 1994 and expects to achieve it in FY 1998. 1% of the FY 1997 General Funds budget is $5.7 million. FY 1997 General Fund multiyear commitments for which a funding source has not been identified total $6.0 million.

OPERATIONS

These goals are designed to formalize good business practices in the day to day financial operations of the University. They include the following:

• The University should maintain working cash balances of 30 days of revenue for all funds - this is the generally accepted standard and assures timely payment of bills regardless of fluctuations in revenues.

• All idle funds should be invested to ensure maximum return consistent with flexibility and safety of principle - this is already University policy. All cash balances are invested by the Treasurer.

• All endowment funds should be invested to insure maximum return consistent with safety of principle and the strategic objectives of the University - this is already University policy and has been formalized by a Board of Trustees resolution.
• The University should pay all properly documented bills in no more than 30 days - Accounts Payable has a policy that it will pay all properly documented bills within 10 working days after being received by Account Payable. This approach is more meaningful to the University’s external customers and more consistent with common business practices.

• University funded annual debt service should not exceed 5% of annual University income from all funds - the University is well under this threshold currently, but more by accident than design. Adopting this policy would protect the University from over extending itself by incurring additional debt and is consistent with the guidelines developed by the State of Ohio for this purpose and consistent with the informal guidelines used by the external rating agencies.

REPORTING

Timely and accurate financial reports are essential for the Board of Trustees to meet their fiduciary responsibilities. Good reporting practices include:

• The University's audited financial statements should be reported annually to the Board of Trustees and presented consistent with Generally Accepted Accounting Principles - this is already University practice and has been for some time.

• The Board of Trustees should receive a quarterly budget report which highlights significant trends and potential problems - this is already University practice but needs to be formalized.

• The Board of Trustees should receive an annual report which displays budget v. actual results - the University has periodically provided the Board of Trustees with quarterly budget reports, but has not provided annual budget to actual reports. The appropriate operating practice in both the public and private sector is to provide both. quarterly and annual reports of this nature. It would be in the University's best interest to follow this practice.

Office of Finance
4/28/97
## Status of Reserve Accounts

<table>
<thead>
<tr>
<th>Account</th>
<th>Sept. 06 Amount (in millions)</th>
<th>Target Amount (in millions)</th>
<th>Target Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General Fund</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rainy Day Fund</td>
<td>$12.5</td>
<td>$11.2</td>
<td>1% of University's annual general funds expense</td>
</tr>
<tr>
<td>Enrollment Reserve/College Stabilization</td>
<td>3.3</td>
<td>6.8</td>
<td>1% of annual tuition and IDC's</td>
</tr>
<tr>
<td>Utility Reserve</td>
<td>5.2</td>
<td>12.6</td>
<td>15% of annual expense</td>
</tr>
<tr>
<td>Financial Aid Reserve</td>
<td>(0.2)</td>
<td>3.4</td>
<td>5% of annual expense</td>
</tr>
<tr>
<td>Legal Reserve</td>
<td>2.0</td>
<td>1.0</td>
<td>$1 million</td>
</tr>
<tr>
<td>Property &amp; Liability Insurance Reserve</td>
<td>3.4</td>
<td>5.0</td>
<td>Size of deductible</td>
</tr>
<tr>
<td><strong>Sub Total</strong></td>
<td><strong>$26.2</strong></td>
<td><strong>$40.00</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Non-General Fund</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malpractice Insurance Reserve</td>
<td>104.1</td>
<td>90.9</td>
<td>Actuarially determined</td>
</tr>
<tr>
<td>Debt Retirement Reserve</td>
<td>53.0</td>
<td>48.0</td>
<td>One year's principal payment on all general receipt bonds</td>
</tr>
<tr>
<td>Health Benefits Reserve</td>
<td>16.0</td>
<td>13.5</td>
<td>One month of total claims and administrative costs</td>
</tr>
<tr>
<td><strong>Sub Total</strong></td>
<td><strong>173.1</strong></td>
<td><strong>152.4</strong></td>
<td></td>
</tr>
</tbody>
</table>
## COMPARISON OF 1997 FINANCIAL PERFORMANCE OBJECTIVES WITH THE 2007 PROPOSAL

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Fund Operating Margin</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>Uncommitted Fund Balance</td>
<td>5% of GF Revenues</td>
<td>1% of GF Revenues</td>
</tr>
<tr>
<td>Working Cash Balance for All Funds</td>
<td>30 Days</td>
<td>150 Days</td>
</tr>
<tr>
<td>Debt Service as a Percent of Annual Revenue</td>
<td>No more than 5%</td>
<td>No More than 4%</td>
</tr>
<tr>
<td>Credit Rating</td>
<td>AA</td>
<td>AA</td>
</tr>
<tr>
<td>SB 6 Ratio</td>
<td>1.8 minimum</td>
<td>3.6 minimum</td>
</tr>
</tbody>
</table>