FY2016 Financial Statement Analysis and Financial Metrics Updates

BACKGROUND

The Oregon State University Annual Financial Report, including the audited financial statements and management's discussion and analysis (MD&A), has been completed and will be presented to the Executive & Audit and Finance & Administration Committees on January 19, 2017. To complement that report, this report provides information on the financial health of the university, including comparison of key financial metrics over time.

OVERVIEW

Public universities operate in a challenging financial environment. Declining and volatile levels of state funding have required universities to reduce costs, gain efficiencies, and look to other sources of revenues through philanthropy, intellectual property, growing their research base, and increasing tuition. The environment in Oregon has been no different. At the same time, Oregon's public universities, because of their role of maintaining access and affordability, have been challenged to hold only a minimum level of reserves. As state entities, public universities in Oregon were not allowed to budget for and set aside operating monies to fund renewal of major Education & General Fund-supported building systems, such as roofs and HVAC. As a result, deferred maintenance has been a growing issue that universities have been grappling to address. These pressures make the financial management of the university an exercise in balancing the competing goals of greater financial strength and security with access and affordability.

Over the past year, the university made investments in capital and human resources and in other operating expenditures needed to keep pace with enrollment growth and to address some of the deferred maintenance backlog. Consequently, the growth in net assets has not kept pace with the growth in our revenue and expenditure base.

TREND ANALYSIS OF SPECIFIC FINANCIAL METRICS

In the following table, we present a trend analysis of seven specific financial metrics to evaluate the university's financial health, including the five debt policy ratios used to evaluate debt capacity and affordability. The debt service amounts shown include only the university-paid debt; amounts exclude debt service on SELP (State Energy Loan Program debt where the legislature has committed to pay the debt service with a separate General Fund appropriation.

The university implemented GASB (Governmental Accounting Standards Board) Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, and GASB Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date – an amendment of GASB Statement No. 68,* effective for the fiscal year ended June 30, 2015. This implementation impacts six of the seven financial metrics with a varying degree of materiality.

For FY2016, the far column on the right shows the ratios without the cumulative impact of GASB 68 and 71 for comparison purposes.

Debt Burden Ratio – The debt burden ratio shows the magnitude of debt service expenditures for university-paid debt relative to the total expenses, less depreciation and plus debt principal

payments. This ratio measures the university's dependence on debt to finance its mission. The debt policy maximum is 7%. The university's debt burden is 3.1% for FY2016, down from 3.4% in FY2012, and within the Board's tolerances, indicating that the university is not highly leveraged. Without the implementation of GASB 68 and 71 this ratio would be 3.4%.

Debt Service Coverage Ratio – The debt service coverage, or debt affordability ratio, measures the sufficiency of net revenues to cover debt service. This ratio uses a three-year rolling average of net revenues to smooth out revenue volatility. The university's debt service coverage was at 1.1 times debt service for FY2016, and was below the lower range of approved tolerances. Without the implementation of GASB 68 and 71 this ratio would be 1.5 times debt service. This ratio has been trending downward since FY2012, which is mainly reflective of the decline in available net revenues for debt service.

Please note that the Debt Service Coverage ratio has been restated for prior years. We previously calculated the ratios incorrectly due to a misinterpretation of the foundation's component of the numerator. The numerator includes the change in the foundation's *unrestricted* net assets. Prior year ratios inadvertently included the foundation's *total change* in net assets.

Income Statement Leverage Ratio – The income statement leverage ratio measures the amount of debt relative to the size of operations as reflected in total revenues. This ratio considers only debt that will be repaid with university revenue. The university's income statement leverage stood at 36.1% for FY2016, down from 38.1% in FY2012. The 36.1% is within the Board's tolerances and shows that the university is not highly leveraged. GASB 68 and 71 does not impact this ratio.

The following four ratios are considered industry standard core measures of financial health. They combine amounts from the OSU Foundation's financial statements (where applicable), which is recommended by industry best practice, in order to portray the financial health of the university more holistically.

Viability Ratio – The viability ratio compares expendable net assets to total outstanding debt to be repaid with university revenues. This ratio measures the ability to repay debt with financial resources and the ability to use debt to strategically advance the university's mission. The university's viability ratio was 76.2% and within the Board's tolerances at June 30, 2016, down from 113.5% as of June 30, 2012. Without the impact of GASB 68 and 71 this ratio would be 104.3%

Primary Reserve Ratio – The primary reserve ratio measures the level of available reserves to meet the university's operating expenditures, whether financial resources are sufficient and flexible enough to support the university's mission. The university's primary reserve, inclusive of the related foundations, was 26.8% as of FY2016 and below the Board's tolerances, down from 43.1% as of FY2012, which reflects growth in the expense base relative to the expendable net assets of the university. Without the impact of GASB 68 and 71 this ratio would be 40.0%.

Return on Net Assets Ratio – The return on net assets ratio measures whether the university is financially better off than in previous years by measuring total economic return. The university's (inclusive of the related foundations) return on net assets was –1.0% for FY2016, which is slightly below the approved lower end of the range of 0.0%. Without the impact of GASB 68 and 71 this ratio would be 5.7%.

Net Operating Revenues Ratio – The net operating revenues ratio explains how the results of operations affects the behavior of the other three core ratios: the viability ratio, the primary reserve ratio, and the return on net assets ratio. A large surplus or deficit directly impacts the amount of funds an institution adds to or subtracts from net assets, thereby affecting the other three core ratios. The university's net operating revenues ratio was –9.1% for FY2016 and below the approved lower end of the range of 0.0%. Without the impact of GASB 68 and 71 this ratio would be –0.7% or slightly below the approved lower end of the range of 0.0%.

Conclusions from Trend Analysis of Specific Financial Metrics – In summary, while the analysis of the trends in the core financial metrics above shows relatively low leverage and balance sheet strength, the university is challenged to continue to show 'income statement' improvements over the next several years in order to strengthen reserves and protect the university's net asset base.

OVERALL CONCLUSIONS

Over the last five years, five of the seven key financial metrics (without the GASB 68 and 71 impact) have generally been within the operating ranges set by the Board of Trustees. These include the debt burden, income statement leverage, viability, primary reserve and return on net assets ratios.

Over this same time period, the debt service coverage (as restated) and net operating revenues ratios have primarily been below the lower level of the operating ranges. Being outside the range in these two ratios does not indicate an immediate concern about OSU's financial health or impact to our AA3 credit rating. We discuss longer-term projected trends of these ratios in the Ten-Year Business Forecast.

Oregon State University - Key Financial Metrics

(Dollar amounts in thousands)

	2012		2013		2014		2015		2015 (w/o GASB impact)		2016		2016 (w/o GASB impact)	
Debt Burden:														
Debt Service[1]	26,571		26,414		26,278		28,570		28,570		33,053		33,053	
Total Adjusted Expenses [2]	779,101	3.4%	825,655	3.2%	888,185	3.0%	898,494	3.2%	951,765	3.0%	1,075,674	3.1%	982,474	3.4%
											range	2.5%-6.5%		
Debt Service Coverage:														
3 yr. avg. Net Revenue available for Debt Service	62,175		48,344		36,400		61,859		44,138		36,580		49,926	
Debt Service [1]	26,571	2.3	26,414	1.8	26,278	1.4	28,570	2.2	28,570	1.5	33,053	1.1	33,053	1.5
											range	2-4.5 times		
Previously reported ratio [6]		*4.8*		*4.4*		*4*		*3.5*						
Income Statement Leverage:														
Debt [1]	325,407		315,963		395,834		452,559		452,559		406,392		406,392	
Revenues	853,282	38.1%	900,638	35.1%	965,880	41.0%	1,062,288	42.6%	1,062,288	42.6%	1,125,370	36.1%	1,125,370	36.1%
											range	30-75%		
Viability:														
Expendable Net Assets [3]	369,483		395,923		426,431		409,657		430,939		309,478		423,960	
Debt *	325,407	113.5%	315,963	125.3%	395,834	107.7%	452,559	90.5%	452,559	95.2%	406,392	76.2%	406,392	104.3%
											range	75%-125%		
Primary Reserve:														
Expendable Net Assets [3]	369,483		395,923		426,431		409,657		430,939		309,478		423,960	
Total Adjusted Expenses [2]	857,497	43.1%	908,202	43.6%	984,169	43.3%	976,306	42.0%	1,029,577	41.9%	1,154,282	26.8%	1,061,082	40.0%
											range	35%-65%		
Return on Net Assets:														
Change in Net Assets [5]	(6,921)		37,039		64,163		105,795		52,524		(13,480)		79,720	
Total Net Assets	1,041,254	-0.7%	1,034,333	3.6%	1,061,090	6.0%	1,050,699	10.1%	1,125,253	4.7%	1,381,161	-1.0%	1,402,444	5.7%
											range	0%-8%		
Net Operating Revenues:														
Inc./(Loss) before Capital & Other	(55,195)		(28,583)		(29,715)		25,295		(27,977)		(101,233)		(8,033)	
Operating plus Nonoperating Revenues	800,627	-6.9%	881,968	-3.2%	1,005,933	-3.0%	1,084,460	2.3%	1,084,460	-2.6%	1,117,523	-9.1%	1,117,523	-0.7%
											range	0%-6%		

[1] Debt service and debt excludes State paid debt, SELP.

[2] Total Expenses: Operating Expenses and Principal and Interest Paid less Depreciation Expense

[3] Expendable Net Assets: Unrestricted Net Assets and Expendable Restricted Net Assets, excluding Capital Projects

[4] Total Adjusted Expenses: Operating Expenses and Interest Expense

[5] Change in Net Assets: Adjusted for Special Item - Change in Entity and Change in Accounting Principle

[6] The Debt Service Coverage ratio has been restated for prior years. The previous ratios were calculated incorrectly due to a miss interpretation of the foundation's component of the numerator. The numerator includes the change in the foundation's *unrestricted* net assets. Prior year ratios inadvertently included the foundation's *total change* in their net assets.

Shading indicates outside the board's tolerances.