RETOOLING YOUR FINANCIAL RESERVES

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Prakash Mathew,
North Dakota State University
NDSU athletic director Taylor leaving for Iowa

Prakash Matthew, who recently retired as NDSU’s vice president for student affairs, will take over as interim athletic director until a replacement is named. Bresciani said it shouldn’t take long.

By DAVE KOI PACE - Associated Press - Monday, June 16, 2014

SNYDER: All-consuming NFL

“Some may not necessarily agree with that. Believe me, I can’t tell you how
LEARNING OBJECTIVES

- Speak with confidence about the importance of financial reserves to the long-term viability of your school.
- Prepare, communicate and update a data-driven reserves policy that will build confidence with your school’s key stakeholders.
- Understand how this policy integrates with your financial planning and reporting.
- Design an interactive process to develop and adjust reserve targets that will engage your staff and governance.
Why Colleges and Universities Need Reserves

→ To bridge cash flow needs
→ To maintain financial solvency
→ To weather economic cycles
→ To fund expected opportunities
→ To fund unexpected opportunities
→ To protect yourselves against unpredictable political behavior
→ To purchase and maintain productive assets
→ To drive capacity for new debt to fund major capital needs
WHAT WE’RE SEEING AND HEARING

Ohio's universities have almost $3 billion in cash, document shows

Big reserves become factor in state budget debate

Then, on the same day in 2013 in which the UW System president proposed a 2 percent tuition increase, we learned that the System had more than $648 million in cash reserves at the end of the previous fiscal year. It was insulting to students and parents forking over thousands per year to the System.

Campus Use of Financial Reserves Questioned

Winthrop announces 10% budget freeze

Using Winthrop’s reserve fund to balance the operating budget over recent years is not a sustainable way to run the school, Folkens said. In some years, it was reasonable to dip into the reserves, he said, because the account had intentionally been grown to cover one-time costs.
The ability to carry out activities that will achieve your mission while also developing and maintaining capacity for mission relevance in the future.
THE CHARGE

I. General Information

A. Purpose
This Request for Proposal (RFP) is to contract with North Dakota State University’s (NDSU) Division of Student Affairs (Student Affairs) to perform a financial assessment and review of Student Affairs’ current finances and offer objective and expert recommendations on account balance strategies for future planning needs.

- Perform an assessment of the reserves required for expected and unexpected future events and recommendations to maintain financial activities.
- Estimate funds available for assisting other University departments and activities.
- Recommend account balance strategies for future planning needs including potential designation of restricted fund accounts.
NDSU Division of Student Affairs

- Provides services, programs and resources for students in support of academic, professional and personal growth.

- Three units and twenty departments:

  [Diagram showing roles and responsibilities]

  - Vice President for Student Affairs
    - Associate VP for Student Affairs:
      - Admission
      - Bison Connection
      - Career Center
      - Enrollment Mgmt Tech Svcs
      - Orientation and Student Success
      - Registration and Records
      - Student Financial Services
    - Dean for Student Wellness:
      - Counseling Center
      - Disability Services
      - Student Health Service
      - Wellness Center
    - Dean of Student Life:
      - Bookstore, NDSU
      - Dining Services
      - Memorial Union
      - Residence Life
      - Student Life, Dean of
      - TRIO

- $40M from primary revenue sources: student fees, retail sales (dining services, bookstore), housing fees, contract dining.

- Exercised bonding authority for construction of revenue-generating facilities; obligations on SA’s financial statements.
1 Approach / 2 Phases / 6 Steps

**Phase 1:**
- Review of Current Policy and Practice
- Data Collection (via Survey)
- Facilitated Stakeholder Sessions
- Quantitative Modeling
- Draft Policy Recommendations
- Governance Approvals

**Phase 2:**
- Identify risks to major divisions / departments
- Phase 2: Quantify identified risks and build appropriate policy
- Iterative Feedback Loop
Review of Current Policy and Practice

- Current reserve policy and historical context
- Business and financial reporting structure
- Historical reserve targets vs. actual performance and use
- Credit rating reports
- Related risk (e.g. SWOT) or strategic planning documents for each program, department, or entity-wide
- Capital improvement plans
- Investment allocation risk analytics
DATA COLLECTION (VIA SURVEY)

→ Suggest surveying internal departmental directors
  ◦ Direct service delivery at the departmental or site level
  ◦ Business and finance
  ◦ Information technology
  ◦ Physical plant

→ Questions revolved around...
  ◦ Identifying specific business risks
  ◦ The likelihood and timing of their occurrence
  ◦ Their anticipated financial impact
  ◦ Their categorical nature
  ◦ Alternative mitigation strategies
**Sample Survey Questions**

- True or False: SA’s current reserves policy works well.
- What are the most critical cost drivers in your department?
- Keeping both your cost drivers and income sources in mind, what potential high impact risks could result in your department’s need to access SA reserve dollars?

*It is important that [ ] as a whole, maintain reserves for the following reasons:*

- To adjust for bad years
- To support initiatives and opportunities
- To react to changes in the business model
- To survive large scale change
- To respond of emergencies
- To provide stability
- To pay for litigation
- It’s just good practice

[Other (please specify):]
SAMPLE SURVEY QUESTIONS (CONT’D)

The likelihood of this risk affecting us is:

- Low (25% or less)
- Medium
- High (75% or higher)

If this risk is going to affect us, it will do so within the following time frame:

- Up to 12 months
- 1 - 3 years
- 3 - 5 years
- 5 - 10 years
- > 10 years

If this risk were to affect us, it would result in what financial harm to the organizational unit? *(Please be specific but concise in providing an aggregate dollar impact and the duration of impact projected.)*

How much of this impact *(in dollars or percent)* will you be able to mitigate without access to reserves?

Taking into account the responses above, this risk best fits into which of the following categories?

- Operating: *to fund ongoing operational expenses during economic disruption (< 12 months)*
- Capital Improvement: *to fund major information technology and facility needs*
- Business Model: *to fund operations over a 3-year period during a significant change in the or OU model*
- Legal: *to fund costs associated with litigation*
- Market Volatility: *to fund unanticipated investment losses caused by market volatility*
- Initiative: *to fund business initiatives requiring significant developmental or start-up costs*
(Optional) Facilitated Stakeholder Sessions

Goals:

- Test departments’ response to seeing the survey data in aggregate
- Fill any data gaps or clarify items that required interpretation
- Move to consensus, most likely scenario for each identified risk
- Test the materiality of smaller risks identified
- Explore rationale in assigning likelihood, timing, and financial impact
- Test risks identified by other respondents to ensure they are:
  - Appropriately excluded
  - Void of any overlaps and disputes
SAMPLE SESSION AGENDA

- Introduction and Perspectives of Participants
- Review Committee Charge
- Ground Rules
  - Risks vs. Opportunities
  - Insurable vs. Uninsurable Risks
  - Budgeted New Initiatives vs. Reserve Contingencies
- Review of Survey
  - Agree on nature, likelihood, impact timing, and dollar exposure
  - Review proposed financial model conventions
  - Consider overlap with other operating units or departments
  - Identify additional reserve requirements
  - Agree on adjustments to survey results
- Open Discussion and Wrap-Up
ON TO PHASE 2

Review of Current Policy and Practice

Data Collection (via Survey)

Phase 1: Identify risks to major divisions / departments

Facilitated Stakeholder Sessions

Quantitative Modeling

Draft Policy Recommendations

Governance Approvals

Phase 2: Quantify identified risks and build appropriate policy

Iterative Feedback Loop
Quantitative Modeling

Objective: To develop a data-driven financial reserve model that quantifies the risks identified in surveys and stakeholder sessions against SA’s current reserve levels, and that provides SA with a reasonably comprehensive yet practical tool to carry forward.

Result: A compilation of total financial risk that can be analyzed by various characteristics – reserve type, time horizon, likelihood, etc.
**Reserve Model Schematic**

**Individual Risks**
Qualitatively describes the discrete risks facing each operating unit

**Risk Classifications**
Defines the nature of each risk according to survey classifications

**Reserve Types**
Reorganizes risks to better reflect the true nature of operating contingencies

**Feedback Loop for Regular Assessment & Adjustment**

**Summary & Visuals**
Provides a summarized data file and visual representation of reserves

**Monetized Impact**
Assigns concrete dollar values to each risk

**Likelihood and Timing**
Assigns a likelihood and expected timing to each identified risk
RECOMMENDED RESERVE CATEGORIES

Enrollment
A reduction in enrollment due to environmental, competitive, and functional factors.

Net Tuition Variance
A reduction or shift in tuition due to economic downturn, political change, or statute.

Fundraising Activities
Poor performance on fundraising or grant-seeking activities.

Debt Compliance and Capacity
To meet covenants on existing debt and fuel capacity for new debt to fund major capital needs.
RECOMMENDED RESERVE CATEGORIES

Capital Investment
Repair, replacement, or expansion of major physical and technological infrastructure.

Employment Funds
Uninsurable litigation risks.

Major Initiatives
Entity-wide strategic undertakings not yet executed.

Other Unplanned Contingencies
Unclassified ongoing business risks.
Projected requirement of $10 million at full risk valuation. Recommended reserve categories are as follows.

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Investment</td>
<td>$2,300,000</td>
<td>23%</td>
</tr>
<tr>
<td>Major Initiatives</td>
<td>$2,300,000</td>
<td>23%</td>
</tr>
<tr>
<td>Net Tuition Variance</td>
<td>$1,700,000</td>
<td>17%</td>
</tr>
<tr>
<td>Enrollment</td>
<td>$1,000,000</td>
<td>10%</td>
</tr>
<tr>
<td>Fundraising Activities</td>
<td>$400,000</td>
<td>4%</td>
</tr>
<tr>
<td>Debt Compliance and Capacity</td>
<td>$400,000</td>
<td>4%</td>
</tr>
<tr>
<td>Employments Funds</td>
<td>$400,000</td>
<td>4%</td>
</tr>
<tr>
<td>Other Unplanned Contingencies</td>
<td>$1,500,000</td>
<td>15%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$10,000,000</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>
NOT EVERYTHING WILL HAPPEN AT ONCE

A reserve level of approximately $7.1M would capture all risks assigned either a medium or high likelihood and a time horizon of 5 years or less.

...accounts for 71% of all identified risks at full their valuation.

...represents 52% of forecasted fiscal year 2014 operating expenses.

...offers a subjectively reasonable bottom range.
RECOMMENDATION

Based on current risks and forecasted fiscal year 2014 operating expenses of $13.7 million, SA should maintain reserve levels between $7.1 million and $10 million.

<table>
<thead>
<tr>
<th>Reserve Level</th>
<th>% of Forecasted FY14 Expenses</th>
<th>% of Current Risks at Full Value</th>
<th>Amount Over / (Under) Current Reserve Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ceiling</td>
<td>$10 Million</td>
<td>73%</td>
<td>$1 Million Over</td>
</tr>
<tr>
<td>Current</td>
<td>$9 Million</td>
<td>66%</td>
<td>–</td>
</tr>
<tr>
<td>Baseline</td>
<td>$7.1 Million</td>
<td>52%</td>
<td>$1.9 Million Under</td>
</tr>
</tbody>
</table>

Based on the table above, SA should maintain reserve levels between $7.1 million and $10 million to align with current risks and forecasted fiscal year 2014 operating expenses.
OTHER CONSIDERATIONS

- The nature of these risks will continue changing
- Our recommendation is not a static range
- SA will need to update the data model for significant budget growth or reduction and changing risk profile based on activities

Possible methodologies for further refinement
  - Subjective Scenario Modeling: Interactive, more variability
  - Regression Analysis
    - Expected Value: Simplistic, would likely undervalue reserve needs
    - Normal (Gaussian) Distribution
      - 1 Standard Deviation = 68% of fully valued risks
      - 2 Standard Deviations = 95% of fully valued risks
Proposal: Change our Reserves Policy

From the present...
- The minimum recommended goal is to have reserves at least equal to one half of the total budgeted yearly expenditures.

To a policy based on a data-driven approach...
- Total Reserves Risks / Exposure of the SA
The Total Reserves Risks (TRR) shall be the sum of all reasonable potential draws on our reserves.

- We will use a bottom-up method to determine TRR.

FinCom will annually determine TRR update process.

- FinCom will conduct reviews at least once every three years.

The lower and upper reserve targets shall be determined by FinCom as follows:

- Lower: $7.1 million (Today = 71% of current TRR)
- Upper: $10 million (Today = 100% of current TRR)
FinCom will annually set target points as dollar amounts.
- FinCom will review and recommend annually or upon major changes for approval. Treasurer can call for a review as needed.

The state of the actual reserves will be tracked and reported in FinCom’s monthly financial reporting package.
- Actual reserves are defined as the reserves market value minus forecasted reserves spending plus forecasted operations surplus

If reserves fall below the lower reserves target...
- Treasurer will notify President and hold a FinCom discussion within two weeks.
- FinCom will recommend any suggested actions.
RISK IS...RISKY...WHAT TO WATCH OUT FOR

- Segregate current risks from hypothetical ones.
  - Conversely, changes in strategic direction warrant reassessment.

- Know which risks should be mitigated through insurance and/or litigation rather than reserves.

- Separate reasonable, ongoing risks to your school from singular catastrophic events that could jeopardize entity-wide solvency.

- Beware of duplicative risks.

- Address the nuances of precedent relationships between risks when analyzing for aggregate financial impact.
PARTING WORDS OF WISDOM
THANK YOU.

FOR FURTHER INFORMATION, PLEASE CONTACT:

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