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MEMORANDUM

DATE: September 27, 2012

TO: System Budget Advisory Committee

FROM: Benjamin F. Quillian B.Q.
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SUBJECT: **Unrestricted Net Assets**

As you know, questions have been raised about the Unrestricted Net Assets reported in the CSU Audited Financial Statements. Some of our colleagues believe the increases in the amount of Unrestricted Net Assets suggest that the administration is building and hoarding "a large pot of money" that could be put to better use. This memorandum is intended to define Unrestricted Net Assets, elucidate the restrictions on and uses of the cash balances, and explain why it is important to build cash balances in the current fiscal environment. Unrestricted Net Asset (UNA) balances are found in the CSU Audited Financial Statements by fiscal year and are available for review at http://www.calstate.edu/SFSR/GAAP/financial_statements.shtml.

Unrestricted Net Assets

The Unrestricted Net Assets category has two components: designated and undesignated. The *designated* funds represent the revenue streams associated with specific programs, and the funds are used for those specific programs. As of June 30, 2011, the *designated* UNA balances totaled $1.19 billion in various CSU funds.[1]

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[1] Approximately 58% was designated for supporting enterprise activities (e.g., continuing education, housing, parking, student union), 16% was designated for campus-based programs/projects, and 12% was designated for special capital projects. The remaining 14% was designated for supporting activities related to education, financial aid, and future liability claims.

The *undesignated* funds refer to the Operating Fund and the General Fund Appropriation from the State. The primary sources of revenue for the *undesignated* funds are: 1) reimbursements from the General Fund Appropriation to pay the payroll expenses; and 2) tuition fees and various student fees identified in the CSU fee policy.

As of June 30, 2011, the *undesignated* UNA had a balance of $643 million in the Operating Fund – a little more than two months of CSU payroll expenses. Included in the undesignated balance were unfunded retiree health and dental benefits of $129 million (versus $90 million the prior year). There were also approximately $20 million in financial aid obligations and $329 million earmarked for other University needs, leaving a balance of $165 million. The financial statements for June 30, 2012 are not yet available; however, the *undesignated* UNA balance appears to have decreased slightly from the prior year while unfunded retiree health and dental benefit liabilities have increased to approximately $173 million.

It is also worth noting that consistent with generally accepted accounting principles (GAAP), the University does not record all of its obligations as liabilities in the financial statements. Consequently, the effect on the financial statements is a net asset balance that may appear inflated, but the obligations against that balance are substantial and include financial aid and unfunded pension benefit liabilities.[2]

Cash Balances to Mitigate the Impact of Budget Cuts and Unforeseen Demands from the State

In the context of the severe cuts to CSU's state appropriations, it has been necessary to use some of the cash balances to "buy time" until more sustainable solutions could be implemented. The cash balances have been called on to avoid massive layoffs and maintain as much quality as possible in the academic offerings and student support areas. Cash balances have also helped avoid even greater increases in tuition fees and steeper reductions in enrollment. Moreover, the cash balances have been used to address unforeseen demands from the State. For example, in 2009 the University was called upon to cover temporarily its own payroll expenses, which approach $300 million per month. If cash reserves had been insufficient to do so, it would have been necessary to issue vouchers to employees, impose temporary layoffs, or extend furloughs.

In these very difficult times, it has become important to increase strategically cash balances to enable the University to respond to emergent demands and the unprecedented budget cuts. It is prudent to be prepared as much as possible for the potential of additional cuts (like the looming $250 million "trigger" that will be pulled if the Governor's tax initiative fails) and future demands from the state.

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[2] According to CSU's external auditors, KPMG, the Governmental Accounting Standards Board (GASB) is currently making changes and will require the recording of these liabilities in future years' statements.

For that reason, the CSU has been purposeful in maintaining cash balances to guard against unforeseen requirements of the State and further downturns in the economy. However, depleting the University's cash balances and thereby weakening its financial position would have far-reaching consequences to the University's ability to address unforeseen demands from the State, manage emergencies and cash flow challenges, meet obligations not reflected on the CSU balance sheet, and maintain its credit rating.

The Effect of Liquidity on Rate of Borrowing and Rate of Return

With more than $4.5 billion in long-term debt, debt service cost is a major component of the CSU's budget. The University's debt service cost (the cost to borrow) is directly linked to the health of the financial statements and is reflected in its credit rating. As seen in other governmental agencies, a drop in credit rating can be very costly in terms of cost of funds. Accordingly, the CSU has worked diligently during this stressful economic period to maintain its financial condition in a manner that will protect its current credit ratings.[3] Significant reductions in cash balances would put the credit ratings at risk. Liquidity is a key component in credit ratings. Thus it would not be prudent to reduce cash balances significantly. Additionally, the University's ability to take advantage of the higher returns available in the State Agency Investment Fund (SAIF) would be jeopardized if the cash balances fell below certain levels.[4]

Summary

The use of cash balances has allowed CSU employees to receive paychecks as scheduled, prevented massive layoffs, kept tuition increases from being even higher, and kept decreases in enrollment from being greater. The continued use of cash reserves, however, is not sustainable for many of the reasons mentioned above. The CSU must maintain enough cash to cover unanticipated obligations and expenses and keep the cost of borrowing low. The June 30, 2011 balance barely covers two months of payroll. The University wants to make sure employees continue to receive paychecks were the State again to require the CSU to cover its own payroll. The University strives to provide its students with the level of quality in academic offerings and support they deserve. In the current fiscal environment and with the many other obligations and possible unpredictable uses of University funds, it could be argued that the balances are still too low.

I trust this memorandum has provided some context for the maintenance of cash balances and explained the need for those balances.

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[3] Aa2, stable outlook, with Moody's; A+, positive outlook, with S&P; ratings that are higher than the State of California.
[4] SAIF is a special fund created by the legislature in which the CSU and other state agencies may invest and earn higher rates of return than other available conservative investment options.