“Responsibility-Based Budgeting”

Sponsor

Office of Quality and Continuous Learning

The University of Toledo

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Learning Outcomes

- This interactive seminar will allow you to explore the pros and cons of Responsibility-Based Budgeting (RBB) and financial responsibility in the academic setting of our University

- The concept of RBB is based on the model of incentive funding awarded to colleges and schools for generating enrollment growth

- This largely decentralized financial management process rewards deans and directors with increased financial control over their areas after they continue to demonstrate fiscally responsible management of resources

- You will discuss and analyze the effectiveness of this form of incentive and accountability system in an academic setting and consider the long-term impact on the fiscal health of our University

The Case for Decentralized Financial Management

Responsibility-Based Budgeting attempts to couple academic authority with financial responsibility

At The University of Toledo, the jury is still out on whether to adopt this method permanently, make only modifications, or stick with the status quo

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The Start of the Conversation

The merger of the University of Toledo (UT) and the Medical University of Ohio in July 2006 created the third largest university in Ohio

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Early Interest in RBB

In early 2008, the deans of business and education asked, "What’s the next step toward implementing RBB?”

Understanding Responsibility-Based Budgeting

The University began with a review of a National Association of College and University Business Officers (NACUBO) monograph, "Responsibility Center Management: Lessons From 25 Years of Decentralized Management," published in 2002

Responsibility-Based Budgeting in Brief

The monograph "Responsibility Center Management: Lessons From 25 Years of Decentralized Management," by Jon Strauss and John Curry, concisely describes responsibility-based budgeting and its strengths and weaknesses

1. Academic Authority with Financial Responsibility

Essentially a decentralized model of financial management, RBB attempts to couple academic authority with financial responsibility; college and departmental ownership of their revenues is coupled with the responsibility of paying both the direct and indirect costs, maintaining adequate financial reserves for the applicable unit, and funding annual debt service requirements on attributable debt

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2. Some Centralization Still Necessary

RBB retains a certain amount of centralization to remedy inter-unit financial disparities (such as the inability to charge differential tuition in some states) and to implement university-wide strategic plans

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3. Changing Role of the “Chief Financial Officer”

RBB changes the role of the university’s chief financial officer from a central financial manager to more of a central banking and rating agency analyst; the chief financial officer establishes the financial parameters within which colleges and departments must operate, determines whether colleges and departments can borrow money from the university, and periodically evaluates the financial health of each college or department

4. “Fully Loaded” Department Financial Statements

RBB requires fully loaded (including direct and indirect costs) financial statements at the college and departmental levels; The University determines revenue and indirect cost allocation methodologies, which should be as simple as possible (e.g., based on credit hours taught, space occupancy, and full-time-equivalent employees)

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5. Incentives, Rewards, and Accountability

Incentives, rewards, and sanctions are necessary to effectively implement and sustain RBB; deans and department heads are given more control over their finances, but they are also held accountable for a more complex set of financial responsibilities

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Responsibility-Based Budgeting in Brief

To obtain a copy of the monograph, go to www.nacubo.org/x43.xml and

enter "Strauss and Curry" in the search box

Considering a New Budget Process for UT

After reviewing RBB principles, the chief financial officer thought about how they might work at The University of Toledo

1. Build the Financial Reporting to Support RBB

- No matter the extent to which we would ultimately decide to implement RBB, we knew the university's central business office needed to produce historical college and departmental financial statements for the most recent fiscal year as a baseline for preparing budgets consistent with RBB principles for the next fiscal year

- Two elements of the financial statements in the table merit special attention: "University tax" and "Reallocated funds--Discretionary"

Arts and Sciences—RBB Financial Statement

All Unrestricted Funds (in $ millions)	FY07-08 Actual	FY08-09 Budget
Cash and investments	$50	$53
Debt	50	60
Income statement		
Direct revenues		
Tuition and fees	100	105
Financial aid	(30)	(32)
Gifts and grants	20	22
Other	10	10
Total net revenues	100	105
Direct expenses		
Salaries and benefits	50	51
Departmental	7	8
Other	3	3

All Unrestricted Funds (in $ millions)	FY07-08 Actual	FY08-09 Budget
Indirect expenses		
Facilities	10	11
Admin. services	20	20
Total expenses	90	93
Operating income	10	12
University tax (10 percent of revenues)	(10)	(11)
Reallocated funds—Discretionary	5	5
Capital expenditures	(5)	(5)
Debt service	(3)	(3)
Add back noncash items	5	5
Net cash flow	2	3

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2. Communicate Financial Standards to Departments

- This is the critical step that couples academic authority with financial responsibility
- In the role of central banker and rating agency analyst, the university's chief financial officer is instrumental in laying out the financial standards that define acceptable RBB financial performance and creditworthiness for colleges and auxiliaries

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Unrestricted Cash Investments to Expenses

The ratio of unrestricted cash and investments to budgeted/actual expenses for a college or auxiliary unit shall not drop below 0.4:1

Unrestricted Cash & Investments to Attributed Debt

The ratio of unrestricted cash and investments to attributed debt for a college or auxiliary unit shall not drop below 0.7:1

Annual Debt Service As a % of Operating Revenues

The maximum annual debt service (MADS) as a percent of operating revenues for a college or auxiliary unit shall not exceed 5 percent

More about Ratios …

Colleges and auxiliary units would be expected to stay within the noted financial parameters at all times

3. Communicate Benefits of Financial Performance

In conversations will deans and their financial staffs, The University has tried to emphasize that RBB is the coupling of responsibility and authority and, most importantly, the coupling of authority and accountability

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Weighing Benefits and Distractions

Before deciding to head down this path, The University wanted to make sure that deans and others properly evaluated the pros and cons of responsibility-based budgeting.

Perceived Strengths and Weaknesses of RBB

STRENGTHS

- Encourages entrepreneurial decisions
- Couples academic and financial decisions
- Rewards positive change immediately
- Pushes decision making closer to faculty
- Increases financial transparency

WEAKNESSES

- Puts financial decisions nearer to college politics
- Adds complexity to the dean and chair roles
- Puts deans and chairs more at risk of losing jobs
- Adds financial staff to colleges and departments.
- Invites preoccupation with allocation rules

Financial Transparency

Another positive result is the increase in financial transparency, which is consistent with notions of academic shared governance and broader concepts of effective corporate governance, both of which depend on active dialogue that is informed by relevant and reliable information

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Financial Decision Making Authority

First among RBB's weaknesses is that it places more financial decision making authority at a level in the university that is arguably the most political

Financial Complexity for Dean/Department Head

A second weakness of RBB is that it adds financial complexity to the role of dean or department head

Revenue and Indirect Cost Allocation Methodologies

A third weakness of RBB is that it invites seemingly endless conversations and arguments about revenue and indirect cost allocation methodologies

RBB at The University of Toledo

Over the past several years, the deans and the chief financial officer

have studied and discussed RBB; they have weighed its pros and cons

Moving Forward with RBB Principles

Participants also agreed that the central business office should move forward with plans to prepare financial statements and budgets consistent with RBB principles for illustrative purposes, and that it should invite administrators from universities employing RBB to inform the conversation at the University of Toledo.

In Conclusion …

RBB has provided a method by which University of Toledo deans and department chairs are able to reward entrepreneurial behavior in their colleges and departments in a transparent and progressive fashion

Small Group Exercise

1. In groups of three, please discuss the nature of the budgeting process within your department/organization.

2. Identify 3-5 positive qualities about the budgeting process.

3. Identify 3-5 opportunity areas for improvement within the budgeting process.

4. Please be prepared to discuss your findings/observation when the class reconvenes

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Classroom Exercise

Linking Budget Development to University Strategy

1. Leadership sets strategic goals before business units begin developing budgets.

Classroom Exercise

2. Business units are responsible for their own risk management initiatives.

Classroom Exercise

3. XYZ Company relies exclusively on financial measures to chart progress toward strategic goals.

Classroom Exercise

4. Performance data from the business-unit level provides information for strategy setting.

Classroom Exercise

5. XYZ Company trains managers in strategic goal setting.

Classroom Exercise

<u>Leveraging Technology to Facilitate Continuous Budget Planning</u>

6. XYZ Company uses a web-based budgeting and planning tool.

Classroom Exercise

7. XYZ Company relies mainly on software vendors' recommendations when selecting features for its budgeting and planning tools.

Classroom Exercise

8. XYZ Company’s budget-planning system is integrated with other University systems.

Classroom Exercise

9. XYZ Company trains managers and employees companywide on the use of budget-planning software.

Classroom Exercise

Tying Employee Incentives to Performance Measures That Exceed Budget Targets

10. XYZ Company uses the same general performance measures for all business units and functional areas.

Classroom Exercise

11. XYZ Company links its incentives programs to specific strategic objectives.

Classroom Exercise

12. Management explicitly identifies factors that are outside the control of subordinates.

Classroom Exercise

13. Business unit managers do not have the authority to transfer funds between capital and operating budgets.

Classroom Exercise

14. Managers hold regular training sessions about incentives programs for employees of all levels.

Classroom Exercise

Incorporating Cost Management into Budgeting

15. XYZ Company uses general ledger account categories when developing costs.

Classroom Exercise

16. Different divisions within XYZ Company use different costing methods.

Classroom Exercise

17. Managers use variance analysis to understand costs and develop budgets.

Classroom Exercise

18. XYZ Company provides managers with cost-management tools and training.

Classroom Exercise

<u>Reducing Budget Complexity and Cycle Time</u>

19. XYZ Company controls the number of budgets developed.

Classroom Exercise

20. XYZ Company has standardized budgeting methods for all of its divisions.

Classroom Exercise

21. XYZ Company works to reduce the number of line items in the budget.

Classroom Exercise

22. XYZ Company uses a budget performance management (BPM) system.

Classroom Exercise

Using Forecasting to Build Flexibility into Budgets

23. XYZ Company bases its budget on factors that drive XYZ Company's business.

Classroom Exercise

24. XYZ Company uses an annual forecasting process to support budget development.

Classroom Exercise

25. Managers are able to communicate the long-term benefits of rolling forecasts to employees.

Classroom Exercise

26. Managers evaluate how different assumptions would affect the budget by creating models of those scenarios.

Classroom Exercise

Establishing Allocation Procedures That Support Key Strategies

27. XYZ Company coordinates review of capital and operating budgets, even though their time horizons are different.

Classroom Exercise

28. Cross-functional teams evaluate the impact of major proposals.

Classroom Exercise

29. XYZ Company monitors allocation results and procedures.

Classroom Exercise

30. XYZ Company bases decisions about resource allocation on historical spending as well as on internal and external benchmarking information.

Classroom Exercise

31. Senior management has sole responsibility for decisions about resource allocation.

Classroom Exercise

32. XYZ Company uses one set of performance measures fir evaluating the action plans of all business units.

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