“Responsibility-Based Budgeting”

**Sponsor**
Office of Quality and Continuous Learning  
The University of Toledo

**Instructor**
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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
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.
The merger of the University of Toledo (UT) and the Medical University of Ohio in July 2006 created the third largest university in Ohio.
Early Interest in RBB

In early 2008, the deans of business and education asked, "What’s the next step toward implementing RBB?"
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.
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.
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)
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.
To obtain a copy of the monograph, go to www.nacubo.org/x43.xml and enter "Strauss and Curry" in the search box
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

<table>
<thead>
<tr>
<th>All Unrestricted Funds (in $ millions)</th>
<th>FY07-08 Actual</th>
<th>FY08-09 Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash and investments</strong></td>
<td>$50</td>
<td>$53</td>
</tr>
<tr>
<td><strong>Debt</strong></td>
<td>50</td>
<td>60</td>
</tr>
</tbody>
</table>

### Income statement

<table>
<thead>
<tr>
<th>Direct revenues</th>
<th>FY07-08 Actual</th>
<th>FY08-09 Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tuition and fees</td>
<td>100</td>
<td>105</td>
</tr>
<tr>
<td>Financial aid</td>
<td>(30)</td>
<td>(32)</td>
</tr>
<tr>
<td>Gifts and grants</td>
<td>20</td>
<td>22</td>
</tr>
<tr>
<td>Other</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total net revenues</strong></td>
<td>100</td>
<td>105</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Direct expenses</th>
<th>FY07-08 Actual</th>
<th>FY08-09 Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and benefits</td>
<td>50</td>
<td>51</td>
</tr>
<tr>
<td>Departmental</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Other</td>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>All Unrestricted Funds (in $ millions)</th>
<th>FY07-08 Actual</th>
<th>FY08-09 Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Indirect expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Facilities</td>
<td>10</td>
<td>11</td>
</tr>
<tr>
<td>Admin. services</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td>90</td>
<td>93</td>
</tr>
<tr>
<td><strong>Operating income</strong></td>
<td>10</td>
<td>12</td>
</tr>
<tr>
<td>University tax (10 percent of revenues)</td>
<td>(10)</td>
<td>(11)</td>
</tr>
<tr>
<td>Reallocated funds—Discretionary</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>(5)</td>
<td>(5)</td>
</tr>
<tr>
<td>Debt service</td>
<td>(3)</td>
<td>(3)</td>
</tr>
<tr>
<td><strong>Add back noncash items</strong></td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td><strong>Net cash flow</strong></td>
<td>2</td>
<td>3</td>
</tr>
</tbody>
</table>
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
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
The ratio of unrestricted cash and investments to attributed debt for a college or auxiliary unit shall not drop below 0.7:1
The maximum annual debt service (MADS) as a percent of operating revenues for a college or auxiliary unit shall not exceed 5 percent.
Colleges and auxiliary units would be expected to stay within the noted financial parameters at all times.
In conversations with 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.
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
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.
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.
A second weakness of RBB is that it adds financial complexity to the role of dean or department head.
A third weakness of RBB is that it invites seemingly endless conversations and arguments about revenue and indirect cost allocation methodologies.
Over the past several years, the deans and the chief financial officer have studied and discussed RBB; they have weighed its pros and cons.
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.
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.
Linking Budget Development to University Strategy

1. Leadership sets strategic goals before business units begin developing budgets.
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.
4. Performance data from the business-unit level provides information for strategy setting.
5. XYZ Company trains managers in strategic goal setting.
Leveraging Technology to Facilitate Continuous Budget Planning

6. XYZ Company uses a web-based budgeting and planning tool.
7. XYZ Company relies mainly on software vendors’ recommendations when selecting features for its budgeting and planning tools.
8. XYZ Company’s budget-planning system is integrated with other University systems.
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.
11. XYZ Company links its incentives programs to specific strategic objectives.
12. Management explicitly identifies factors that are outside the control of subordinates.
13. Business unit managers do not have the authority to transfer funds between capital and operating budgets.
14. Managers hold regular training sessions about incentives programs for employees of all levels.
Incorporating Cost Management into Budgeting

15. XYZ Company uses general ledger account categories when developing costs.
16. Different divisions within XYZ Company use different costing methods.
17. Managers use variance analysis to understand costs and develop budgets.
18. XYZ Company provides managers with cost-management tools and training.
Reducing Budget Complexity and Cycle Time

19. XYZ Company controls the number of budgets developed.
20. XYZ Company has standardized budgeting methods for all of its divisions.
21. XYZ Company works to reduce the number of line items in the budget.
22. XYZ Company uses a budget performance management (BPM) system.
Using Forecasting to Build Flexibility into Budgets

23. XYZ Company bases its budget on factors that drive XYZ Company’s business.
24. XYZ Company uses an annual forecasting process to support budget development.
25. Managers are able to communicate the long-term benefits of rolling forecasts to employees.
26. Managers evaluate how different assumptions would affect the budget by creating models of those scenarios.
Establishing Allocation Procedures That Support Key Strategies

27. XYZ Company coordinates review of capital and operating budgets, even though their time horizons are different.
28. Cross-functional teams evaluate the impact of major proposals.
29. XYZ Company monitors allocation results and procedures.
30. XYZ Company bases decisions about resource allocation on historical spending as well as on internal and external benchmarking information.
31. Senior management has sole responsibility for decisions about resource allocation.
32. XYZ Company uses one set of performance measures for evaluating the action plans of all business units.