

THE CASE FOR DECENTRALIZED FINANCIAL MANAGEMENT

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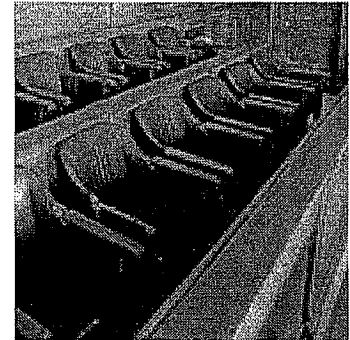
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Responsibility-based budgeting attempts to couple academic authority with financial responsibility. At the University of Toledo, the jury is still out on whether to adopt this method make only modifications, or stick with the status quo.

By Scott Scarborough

The merger of the University of Toledo (UT) and the Medical University of Ohio in July 2006 created the third largest university in Ohio. Not surprisingly, such a transition brought with it many issues and questions. Within about six months, for example, the university's chief business officer (my predecessor) began asking whether the newly constituted university should adopt responsibility-based budgeting (RBB). Such a system might encourage enrollment growth and give deans and department chairs more control over the finances of their colleges and departments. Shortly thereafter, the university took a first step toward RBB when it adopted a modest incentive funding formula that allocated additional resources to colleges and schools that experienced enrollment growth.



When I joined the university in early 2008 as its new chief business officer, the deans of business and education asked, "What's the next step toward implementing RBB?" It was obvious that these deans were eager for more control of the financial resources generated by their colleges and schools. At that point, I set out to review responsibility-based budgeting—its strengths and weaknesses—and how it might work at the University of Toledo.

UNDERSTANDING RESPONSIBILITY-BASED BUDGETING

I began with a review of NACUBO's monograph, "Responsibility Center Management: Lessons From 25 Years of Decentralized Management," published in 2002. The piece, written by Jon Strauss and John Curry, describes RBB's history and underlying principles. Very simply, the responsibility-based budgeting process is a decentralized model of financial management that attempts to couple academic authority with financial responsibility. While a certain amount of centralization remains, the process changes the role of the chief business officer from that of a central financial manager to more of a central banking and rating agency.

analyst. (See sidebar, "[Responsibility-Based Budgeting in Brief](#)," for further details.)

CONSIDERING A NEW BUDGET PROCESS FOR UT

After reviewing RBB principles, I thought about how they might work at the University of Toledo. If we were to adopt this method, we would follow the steps advised by Strauss and Curry. We saw no reason to reinvent the wheel or to think that we were so different from other universities that had adopted RBB as to justify going in a different direction. Our action plan, therefore, was as follows:

1. Build the financial reporting that is necessary 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. The format of the resulting financial statements and budgets is very important because it illustrates how the process really works. For educational purposes, I drafted a sample RBB financial statement and budget for the university's college of arts and sciences (see [Table 1](#)).

Two elements of the financial statements in the table merit special attention: "University tax" and "Reallocated funds—Discretionary." Strauss and Curry do not recommend a pure "each tub on its own bottom" approach to RBB. (This term is often associated with Harvard University's decentralized organization and financial arrangement of its principal academic units, in which each unit or department can support itself.) Instead, they recommend a version that taxes the revenues of colleges and schools as a means by which to fund a central pool that is used by administrators to remedy inter-unit financial disparities, fund universitywide strategic initiatives, subsidize mission-related programs, and fund inter-unit cooperative programs. In [Table 1](#), then, "University tax" is the amount a college or school contributes to the central pool and "Reallocated funds—Discretionary" is the amount a college or school receives from the central pool.

2. Communicate financial standards and parameters to deans and department heads. This is the critical step that couples academic authority with financial responsibility. Ideally, financial standards and parameters are determined and communicated in the context of some form of "balanced scorecard" set of measures. Thus, financial performance of a college or school should always be measured and evaluated in the context of a complete set of performance indicators, which include an evaluation of academic quality, stakeholder satisfaction, and compliance with policies, procedures, rules, and regulations. As Strauss and Curry state in their monograph, "The promise of [RBB] is in joining academic and financial considerations together in the right place."

In the role of central banker and rating agency analyst, the university's chief business officer instrumental in laying out the financial standards that define acceptable RBB financial performance and creditworthiness for colleges and auxiliaries. At UT, it made sense to me to suggest applying the same financial standards to colleges and auxiliaries that the rating agencies currently applied to the university as a whole. This would ensure that the entire university remains financially strong and viable after implementing RBB. Thus, I recommend the following minimum RBB financial standards and parameters for every college and auxiliary unit, using Table 1 to calculate the ratios:

- **The ratio of unrestricted cash and investments to budgeted/actual expenses for a college or auxiliary unit shall not drop below 0.4:1.** For example, the college described in Table 1 would be expected to maintain a minimum unrestricted cash and investment balance of \$37.2 million during FY08-09, which is 40 percent of its FY08-09 total expense
- **The ratio of unrestricted cash and investments to attributed debt for a college or auxiliary unit shall not drop below 0.7:1.** The college represented in Table 1, for example, would be expected to maintain a minimum unrestricted cash and investment balance of \$42 million in FY08-09, which is 70 percent of its FY08-09 debt.
- **The maximum annual debt service (MADS) as a percent of operating revenues for a college or auxiliary unit shall not exceed 5 percent.** That is, since the college illustrate in Table 1 has an FY08-09 MADS percentage of only 2.9 percent (\$3 million in debt service divided by \$105 million in total net revenues), its leadership could decide to issue additional debt up to the 5 percent limit as long as it could simultaneously maintain its unrestricted cash and investment balance above the minimum amounts required by the first two financial parameters.

Colleges and auxiliary units would be expected to stay within the noted financial parameters at all times. If an individual college or auxiliary unit did operate within the above financial parameters, it would be empowered to make its own financial decisions and enjoy the fruit of its success (or suffer the consequences of bad financial decisions). If all colleges and auxiliary units operate within the above financial parameters, the university as a whole remains financially strong because calculations of financial parameters

RESPONSIBILITY-BASED BUDGETING IN BRIEF

The monograph "Responsibility Center Management: Lessons From Years of Decentralized Management," by Jon Strauss and John Curr, concisely describes responsibility-based budgeting and its strengths and weaknesses. In brief, RBB is best described as follows:

- 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.
- 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 universitywide strategic plans.

- o RBB changes the role of the university's chief business officer from a central financial manager to more of a central banking and rating agency analyst; the chief business 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.
- o RBB requires fully loaded (including direct and indirect costs) financial statements at the college and departmental levels; the chief business officer 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).
- o 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/products.html and enter "Strauss and Curry" in the search box.

include the allocation of university indirect costs.

3. Clearly communicate the potential rewards and sanctions associated with varying levels of college and departmental financial performance. In conversations with deans and their financial staffs, I have tried to emphasize that RBB is the coupling of responsibility and authority and, most importantly, the coupling of authority and accountability. On the positive side, if a dean or department head manages a unit's financial performance within acceptable parameters, then he or she is free to add faculty lines, upgrade facilities, increase travel budgets, and so forth. On the negative side, however, if a dean or department head is unable to satisfy minimum financial parameters over an extended period of time, then the dean or department head should be replaced, and corrective actions must be taken to remedy the substandard financial condition of the applicable college or department. The failure to take such corrective action would constitute what Strauss, Curry, and economists call a "moral

hazard," as it would undermine the requisite accountability that is fundamental to RBB and jeopardize the overall financial health of the university.

WEIGHING BENEFITS AND DETRACTIONS

Before deciding to head down this path, I wanted to make sure that deans and others properly evaluated the pros and cons of responsibility-based budgeting. A summary of the perceived strengths and weaknesses that we discussed appears in [Table 2](#). RBB strengths include the coupling of decentralized academic and financial decisions and the potential to enjoy the fruit of one's success, as noted earlier. These facets encourage entrepreneurial behavior at a level of the organization that is closest to university stakeholders.

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. All stakeholders—faculty, staff, trustees, students, administrators, legislators, accrediting bodies, alumni, and so forth—benefit from having access to the financial information that RBB necessitates.

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. The role of dean is already very difficult; deans are relentlessly caught in the middle of often-conflicting expectations of central administrators and college faculty. Central administrators expect deans to function as leaders of change and managers of their colleges. Faculty, however, expect their dean to function less as a manager and more as a faculty advocate; they want to see their dean working hard to secure more resources for their college. The best deans are able to balance both roles, but this is difficult. Under centralized financial management, deans often default to the more politically acceptable role of faculty advocate. Under RBB, however, deans must function first and foremost as strong leaders and managers in the midst of faculty who see the role of the dean as something different.

A second weakness of RBB is that it adds financial complexity to the role of dean or department head. Some deans and department heads will struggle to understand and manage the financial demands of RBB. In fact, Strauss and Curry report that when the University of Denver implemented RBB, "several changes in deans along the way were necessary." To deal with the additional complexity of RBB, many deans and department heads will add to their staffs personnel with more financial experience, which adds to the administrative costs of these units. Universities with centralized financial models concentrate personnel with more financial experience in a central budget office to more cost-effectively support a larger set of colleges and departments. RBB, on the other hand, requires financial

expertise at the unit level. One solution to this problem is to push existing financial staff within central budget offices into the colleges and departments; this helps to mitigate the additional staffing costs typically associated with RBB.

A third weakness of RBB is that it invites seemingly endless conversations and arguments about revenue and indirect cost allocation methodologies. The answer to this problem in the context of shared governance is for the chief business officer to give all constituencies a chance to react to proposed allocation models within a specified time frame, evaluate the feedback, make changes to the proposed models as appropriate, and then move on. Strauss and Curry plainly state, "You cannot make [RBB] perfect by continually refining algorithms and the rules.... Bear 'keep it simple' in mind." As a result, the allocation model that I have recommended allocates tuition and fees to the college of the faculty member who teaches a course, and it allocates indirect costs based on the number of full-time-equivalent employees in the college or the amount of square footage occupied by the college. It is that simple.

RBB AT THE UNIVERSITY OF TOLEDO: TO BE OR NOT TO BE

Over the past few months, the deans and I have studied and discussed RBB; we have weighed its pros and cons. In addition, we invited Jon Strauss to the University of Toledo campus for one day to join and inform our conversations; he was very helpful. I have briefed the president and his cabinet on the strengths and weaknesses of RBB and solicited their input. Our president is very supportive of taking the next steps down the RBB path. The deans and their financial staffs voted unanimously to pursue changes to the university's centralized model of financial management. Roughly half of the deans and their financial staffs, however, thought it best merely to modify the centralized model by adding more funding incentives and increasing transparency. The other half in attendance thought it best to pursue RBB fully and abandon the university's centralized financial model. Everyone, however, agreed to continue the conversation before making a final recommendation to the

TABLE 2: PERCEIVED STRENGTHS AND WEAKNESSES OF RESPONSIBILITY-BASED BUDGETING

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 college and departments.
- Invites preoccupation with allocation rules.

president.

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. Some continue to be concerned that RBB will jeopardize intercollege cooperation and mission-related programs. Other people question whether RBB works at universities with union contracts or with medium-sized endowments and limited discretionary funds. Still others wonder whether RBB really empowers colleges and departments if the university tax and reallocation of funds from a central pool is substantial. One person asked, "I wonder if anything is really accomplished if the university tax and reallocation of funds is used merely to protect the status quo." Finally, everyone questions whether now is the best time to implement RBB, with the nation's economy and state funding for higher education in jeopardy. These are the questions that remain to be answered before deciding to fully implement RBB at UT.

So for now, the RBB question remains: To be or not to be? Either way we go, deans and department chairs want to be able to reward entrepreneurial behavior in their colleges and departments, and they want greater financial transparency. With or without RBB, my financial staff and I need to find ways to satisfy these desires in meaningful and significant ways.

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