February 3, 2014

Dr. Nancy Brickhouse
Dr. Donald Sparks
Co-Chairs, the University of Delaware RBB External Review Committee

Dear Nancy and Don,

I write on behalf of the members of your External Review Committee to convey our findings and recommendations following our meetings with the your internal committee and key stakeholders on January 15, 2014 assessing the University's approach to budgeting and financial management, RBB.

Each member of the Review Committee has sent me his or her findings, recommendations and related commentary. This report will attempt to be both sufficiently inclusive so as not to leave anything of import out, but sufficiently brief so as to make the report easy to read and the recommendations easy to review, revise and implement. As context, I note the extraordinary consistency of individual member's findings and observations; and among their recommendations.

Background

While we did not review extensively the 2009 rationale for implementing a revenue-based budgeting system known as RBB at Delaware (and more generically known as RCM), but we have reviewed and applaud the seven Principles and Objectives for RBB that the Committee developed. We borrow from and expand upon them here as we observe that the most successful implementations:

- Incentivize revenue growth;
- Enhance focus on efficiency and effectiveness of administrative services and space usage;
- Reveal the university's "internal economy" by associating revenues with the costs that generate them (e.g., tuition with instructional budgets, and sponsored research with the units receiving grants and contracts);
- Further reveals the internal economy by allocating indirect costs to the units which consume physical space and administrative services, thus enabling the calculation of net operating margins;
- Keep related rules as simple as possible;
- Balance ownership of revenues between academic units and central leadership to enable both local initiatives and central underwriting of university strategies;
- Foster broad conversations about unit and university specific goals and the best ways to collectively finance them;

- Develop robust engagement processes for annual and long-term budget development, including explicit communication about funding priorities going into the budget cycle, and similarly explicit communication of the results;
- Further foster transparency and managerial efficacy through assuring that data are available to understand both the university's budgeting and financial management system; and to deliver the outcomes that imbedded incentives are intended to aid and abet;
- Hold all units accountable for bottom-line financial performance, and
- Phase in any changes in budget model to minimize major disruptions.

We will engage these characteristics as we assess the current RBB system, and as we move from there to recommendations.

A. Structural Issues with the Current RBB

Assessment A1: The commingling of undergraduate tuition, unrestricted state appropriation, and unrestricted gifts and endowment income into one revenue pool allocated to schools in part (25%) on the basis of dollar volume of sponsored research has many downsides.

- First, it obfuscates the "external economy" since each of these revenues has its unique source - paying students, legislative appropriations, philanthropic donors - one needs to understand the dynamics of each implied "market" and manage growth accordingly. This is not a natural act when looking at a big lump of sources.
- Second, it obfuscates the "internal economy" the allocation of portions of tuition in proportion to research volume decouples the activity from the source, failing to match the revenues with the costs that generate them. In consequence, large research units could look more "profitable" than some primarily teaching units, when in fact the reverse is true. The fact that sponsored research by design does not recover its full costs is lost. Worse, the approach could give rise to perverse strategies such as dramatically increasing foundation and state grants, which bear little or no indirect cost recovery, and thus attracting lots of tuition and state appropriation away from other units into one's own, all the while contributing to overall losses at the university! Insofar as the word "subsidy" is ever appropriate in a university, this allocation methodology is misleading.
- Third, the interaction effects of the commingled revenues with the allocation rule make revenue growth incentives unduly difficult to invoke. One cannot, for example, readily estimate the tuition revenue retained from an initiative to increase undergraduate enrollments in a given program; interactive effects with other changes in the university such as increases elsewhere in research volume, interfere. The primary revenue incentive is vitiated accordingly.

Recommendation A1: Allocate undergraduate tuition, state appropriation, and unrestricted gifts and endowments separately. In particular, allocate **undergraduate tuition** in proportion to (teaching) credit hours.

Recommendation A2: Given your characterization of the ***state appropriation*** as essentially topping up in-state tuitions to the out-of-state level, you might be tempted to allocate the appropriation on the basis of in-state enrollments in the schools. A serious concern about this approach, however, is the association of different incentives with in- and out-of-state students. You probably do not want to do this. You may prefer to assign the appropriation to the ***subvention pool*** along with unrestricted gifts and endowment income. If that is done, we would also suggest an additional tax on school-specific revenues to add to the subvention pool to make it a more diversified. The pool should be sufficient to top up "natural" negative net margins (for innately high cost programs charging the same tuitions as low cost ones) ***and*** to underwrite key university-wide priorities. We heard several concerns about the subvention pool being sufficient only to balance out the schools, with nothing left over to invest in promising initiatives. Further, *subventions should be tied to explicit multi-year plans agreed to between provost and deans, and should not become entitlements!*

Recommendation A3: Allocation of ***financial aid*** somehow did rise to the top of our conversations with you, except for the concern that there seem to be no incentives for deans to raise scholarship support. We make two suggestions: first, that you allocate the undergraduate financial aid managed centrally to schools in proportion to their undergraduate tuition revenues, and exhibit such aid as negative revenue as would be the case in the annual financial statement--thus bringing ***net tuition*** into immediate focus as the real number one needs to manage; and second, that gifts and endowment revenues raised by deans for scholarships show as revenues off-setting the central allocation of financial aid, thus providing a clear incentive to raise money for scholarships.

Assessment A4: The current incentives for research are backward looking, rewarding past levels, distort the understanding of the economics of research at the school level (as explicated above), and do not immediately reward successful research growth initiatives.

Recommendation A4: Since the current system allocates indirect cost recoveries (F&A) to the units whose faculty members are awarded the grants, there already is an incentive to work harder at attracting grants and contracts which pay the negotiated rate - and this will be even more true when tuition and appropriation are allocated as we have suggested above. *We recommend specifically that* **research growth** *be incentivized through subvention allocations.* Deans and or institute heads would propose plans to grow research, and the provost and president would underwrite start-up costs for the most promising ones, with some continuing support potentially a function of increases in the effective F&A rate in the unit.

Assessment A5: While we did not spend much time evaluating the algorithms for allocation space and administrative services, we left with the view that rationalization is needed here just as in the case of revenues. (1) We recommend that allocation rules be revisited and simplified through using only a few allocation bases (sometimes called drivers) such as

student majors (say for enrollment and student services), total number of employees (say for Human Resources), research volume (say for Research Administration), total headcount users (say for IT), square footage occupied (say for Facilities), and total direct expenditures say for all other administrative services (including Finance). Further, (2) we recommend that there be a space broker to effect internal reallocations of space among schools and departments and to develop policies governing out-sourcing and who bears the cost of vacated space. And (3), we recommend rethinking the allocation rules for cost of capital construction, including creating and allocating a deferred maintenance budget in proportion to occupancy. This would essentially socialize deferred maintenance, charging everyone an amount based on square footage, and not on the basis of whether the building they are in is new or old. The central administration would pool these assessments into sufficient sums to do concentrated renovations. In some ways this acts like health insurance without charging a larger premium for pre-existing conditions. To bring sharp focus to potential new projects and whether debt be part of their financing, we suggest you plan with your deans to direct charge debt service on new buildings even if subvention supplements are required.

> ***(An Overarching) Recommendation A6:*** *For each set of potential changes to your RBB structure (essentially changes in allocation rules), simulate the results: Look at the schools and centers through the newly donned conceptual lenses.* You should ask for each simulation: How do we now understand for better or worse our internal economy, and how does each new version enhance or deter easy deployment of incentives - and are they the right incentives? You will see that changes in the rules alter the measures of net margins - what you now call in subsidies, and in an unfortunately pejorative way. Rethink the language - perhaps instead to refer to *net margins* with their algebraic signs.

And a final thought about rules and algorithms: *the Bauhaus maxim, "Less is more," should obtain. A related observation: one cannot incentivize every desired state through adding rules. The more rules, the more opacity; and the more the game is about the rules, not the outcomes, the more the game becomes zero or negative sum. At some point incentives have to be negotiated and managed through the subvention pool (with dollars) or through the authority chain (with personal performance expectations).*

B. Process and Decision Criteria

No matter what the budget structure, good processes and explicit decision criteria matter.

Assessment B1: We got the sense from our conversations with the Review Committee and stakeholders that the overall annual budget process was not well understood. We inferred that university priorities and goals (decision criteria) for the upcoming budget development cycle were not discussed broadly, and in cases where priorities were understood, their budget consequences were not known. Finally, deans and academic personnel were unaware of what was happening with support units' budgets (whose costs the academic units supported through indirect allocations).

Recommendations B1: *Link the components of the annual budget process into one coherent arc. In particular,*

- *Announce clearly and broadly the goals, priorities, planning assumptions and parameters so everyone understands where the university wants to go and the constraints and opportunities that have to be balanced.* This should form the basis for conversations between provost and academic units and between academic units and administrative leaders and support units. Conversations at the unit level would involve funding discipline - and profession-specific needs in the context of contributions to university goals, and how to develop a budget proposal combining local revenues with subvention allocations might best achieve joint goals.
- *Along with the above, lay out the entire budget cycle along with clear demarcations of progress.* Such a roadmap would involve: (1), an analysis of the just ended fiscal year comparing planned net margins with actual margins at the unit and university levels, along with an assessment of what was learned that is relevant to the management of the budget currently in effect and the upcoming planning cycle - realized enrollments, sponsored research volumes, and the state of the state finances would be key foci; (2) the timing of the above goals and priorities communiqué; (3) the timing and contents of the provost's letter calling for budget proposals from the academic units, and the timing and contents of the Executive VP's call for administrative unit proposals; (4) the time period for "hearing the proposals," and for conclusion of revenue and cost vetting and allocation of subventions and administrative budgets; (5) the timing and broad content expectations of letters from the provost and Executive VP communicating the outcomes of budget hearings and how allocations support priorities; and (6) review and authorization of the new budget by the board. (N.B.: knowledge of who talks with whom (presidents, provosts, deans, faculty members, administrative heads, students) about what (priorities, goals, initiatives, key reports and indicators) and when (the calendar) enhances transparency materially.)
- *Consider groups and processes that enable broader participation in budget development: a **budget advisory committee** for example, comprising multiple stakeholders could review and advise on the primary planning parameters such as tuition prices, salary pools, benefits programs, strategic objectives and new initiatives, among other matters; and potentially similar school-specific committees to further participation and understanding among departments.* This is not a hare recommendation given that such a committee would have no real authority to set key numbers like tuition, but it could provide a valuable communication vehicle.

- *Appoint a **costs and services committee,** perhaps a subset of the budget advisory committee with additional decanal representation, to review the efficiency and effectiveness of administrative services, say on a rolling basis involving two units per year.* Administrative heads would benchmark their costs and services against peer institutions, and in some cases outsourcing alternatives; they would provide measures of unmet demand and client satisfaction, perhaps more. The work of this committee would add pressure to service providers, but also enable them to justify their costs and services and in some cases make an open case for added budget. In other cases benchmarks among other measures may point to budget reductions. At the end of each unit's assessment, require that *a service-level agreement be developed,* vetted, and implemented with built-in periodic client satisfaction surveys and benchmark updates. The process involved allows facts to mediate the claims from revenue centers that they are overcharged for administrative services. Again, transparency is furthered.

C. Transparency

Assessment C1: This was a hot button among several stakeholders: deans not knowing what they are getting for the costs they are allocated, and faculty not understanding much about RBB or their schools' internal incentives and allocations. We heard two telling observations from several faculty members: things are transparent from the top down to the deans, but after that it is seven black boxes; or seven adhocracies as another put it. We also observed that the budget process engages unrestricted revenues and expenses but we did not see gifts and endowment revenues restricted to schools and departments and departmental fund balances coming into play - another transparency consideration.

Recommendations C1: (1) We suggest that the provost ask each dean to prepare a policy statement determining: the degrees to which the revenue incentives governing RBB are put into play within her or his school and why; the processes of engagement with chairs, faculty and students that will assure transparency within the school; and the standard communications that will inform stakeholders within the school of priorities and constraints governing budget development, and how funding outcomes were derived. Implementation of the policies would be measured. And **(2)** that the budget formats for each school and the university reveal all funds and fund balances and that budget proposals state how each is being deployed along with unrestricted (general fund) resources.

C. Next Steps and Further Notes

We have several final ***recommendations:***

- *Restructure your RBB system by choosing different rules from the recommendations above (or perhaps others) and simulate each.* Understand how each creates different net operating margins and why. Understand how each aids and abets the incentives you most want to stimulate. The budget director should take the lead in this.

- *Use these simulations to re-engage the RBB Committee in choosing a revised set of rules and the desired new model. Use the simulations and the recommended redesign of the Committee to quickly broaden the circle of faculty and staff who understand how RBB is intended to work.*
- Indeed, at a higher level, and perhaps more immediately, *facilitate a campus wide set of discussions, perhaps designed by the Review Committee, about the philosophy underlying RBB and the kinds of behaviors RBB should incentivize*. The bullet points at the beginning of this report characterizing successful RBB-like systems is a good starting point.
- Along with the processes we have elaborated above, *the President, Provost, and Executive VP need to broadly and collectively address the campus community each Fall as to the goals the university needs to achieve through its annual budget process.*
- *Assure that data are readily available to support budget decisions, and perhaps even more important, to address academic quality issues.* The Institutional Research office should play a major role here.
- *Challenge the facile and pejorative use of words like subsidy, and the readiness to blame RBB for anything that ails any given stakeholder.* Using words like gross (before allocation of indirect costs) and net (after those allocations) operating margins, patiently explaining why some should be negative and others positive based on the relative costs of education, or why some should change their attendant algebraic sign because of untapped market opportunities or excess costs, will go a long way towards correcting currently unfounded characterizations. Current use of words seems to intimate poor management or profligate spending when net margins may well be just in the nature of things. You might turn RBB back into a three-letter word.
- Other questions asked of us suggested (1) allocation of revenues based on degree completion or other desired outcomes - we suggest not doing this since this is not sufficiently in control of the schools and the time lag between trying to improve this statistic and the revenue flow from there is too long; (2) developing rules to mitigate trade wars across schools - we suggest a better way is academic review and curriculum committee control of "calculus in every corner;" and (3) special incentives for summer session teaching - we strongly recommend against this since we have seen a very common consequence - schools shifting critical courses to the term with the most payback.

A few last notes: *You cannot incent everything with rules and money. Leadership and measures of leaders' performances against specific goals are indispensable in any well run organization.* As testimony to the power of leadership, two of us have seen universities with little slack in the subvention pool where schools are expected to and do achieve university-wide goals primarily with their own revenues; that is in consequence of strong leadership expectations and evaluations between the provost and the deans. We would still argue that leadership expectations leavened with subvention allocations is the better way, however!

With these last observations we end our report. We stand eager to receive your feedback and address any concerns. We thoroughly enjoyed our day with you and appreciate the opportunity to help in this important review.

Sincerely yours,

John R. Curry
Managing Director, the Huron Consulting Group,

On behalf of the External Review Committee: Aimee Heeter, Associate Vice Provost and Budget Director, Indiana University; Richard Stanley, Senior Vice President and University Planner, Arizona State University; Julie Tonneson, Associate Vice President and Budget Director, University of Minnesota; and Robert Zemsky, The Learning Alliance, University of Pennsylvania.