Discussion Topics

Huron is pleased to partner with UTK on this important budget redesign initiative and proposes the following goals for today’s conversation:

Meeting Agenda

1. Provide project overview and timeline
2. Present background on University budgeting
3. Outline next steps
Steering Committee Membership

The University has established a Steering Committee to provide guidance for the initiative, to review project status reports, and to validate the opportunities presented.

<table>
<thead>
<tr>
<th>Steering Committee Membership</th>
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</tr>
</thead>
<tbody>
<tr>
<td>David Manderscheid, Provost &amp; Sr. Vice Chancellor</td>
<td>Chris Cimino, Sr. Vice Chancellor, Finance &amp; Administration</td>
</tr>
<tr>
<td>(Co-Chair)</td>
<td>(Co-Chair)</td>
</tr>
<tr>
<td>Phillip Daves, Associate Professor, Haslam College of Business</td>
<td>Kim McCullock, Associate Vice Chancellor, Finance &amp; Administration</td>
</tr>
<tr>
<td>Gary Gray, Assistant Provost, Finance &amp; Administration</td>
<td>Lindsay Melton, Asst. Dean, Finance, College of Nursing</td>
</tr>
<tr>
<td>RJ Hinde, Vice Provost for Academic Affairs</td>
<td>James Price, Executive Director, Budget &amp; Finance</td>
</tr>
<tr>
<td>Terri Lee, Dean, College of Arts &amp; Sciences</td>
<td>Ann Robinson-Craig, Budget Director, College of Arts &amp; Sciences</td>
</tr>
<tr>
<td>Steve Mangum, Dean, Haslam College of Business</td>
<td>Keith Thomas, Director, Budget &amp; Finance</td>
</tr>
<tr>
<td>David Matthews, Associate Dean &amp; Professor, Interior Design</td>
<td>Dixie Thompson, Vice Provost &amp; Dean, Graduate School</td>
</tr>
<tr>
<td>Ami McBride, Budget Director, The College of Engineering</td>
<td>Hongwei Xin, Dean, AgResearch</td>
</tr>
</tbody>
</table>

**Working Group Membership:** Kim McCullock, James Price, Keith Thomas and Gary Gray

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The Steering Committee will be supported by members of Huron¹ who will assist in assessing the current state of budgeting, developing a financial model, and engaging with campus stakeholders.

¹: The Huron team details are available in the appendix
Understanding of Your Needs

Huron understands that UTK hopes to develop a new budget model that will help align its financial resources with the strategic priorities.

As UTK proceeds with its budget model redesign initiative, the University is seeking:

- To develop a budget model that promotes more effective use of resources and allocates funds in a manner that aligns with the University’s core mission and strategic priorities
- To promote student success, stimulate strategic-growth, encourage innovation and entrepreneurship, and support institutional excellence
- Effective incentives for both academic leaders and campus administrators
- Increased transparency and greater correlation between decision making responsibility and the investment of financial resources

Huron understands that UTK has engaged with a consulting partner to:

- Develop a clear understanding of the institution’s model redesign goals
- Build out a pro forma budget model according to the redesigned parameters desired by the University
- Facilitate communication, constituency engagement and stakeholder education surrounding the new model and its relevant process, policy, and operational implications
Project Plan Overview

Huron conducts budget redesign efforts using a multi-phase approach that covers model design, testing, and implementation.

Phase 1: Model Visioning (Aug)
- Understand case for change
- Create common vision for future model

Phase 2: Model Development (Aug – Nov)
- Develop financial model that allows for testing of various resource allocation scenarios

Phase 3: Consensus Building (Nov – Feb)
- Engage stakeholders on customized UTK model
- Co-Chairs will recommend model to Chancellor for approval

Phase 4: Infrastructure Development (Jan – Mar)
- Create governance, processes, training, and select tools and reports to operate new model

Phase 5: Parallel Process
- Operate model in parallel to existing model
- Analyze results and adjust prior to “go-live”
Building a Case for Change

Phase 1: Project Initiation and Visioning (2 weeks)

The objective of this phase is to develop an understanding of the current state and redesign goals in order to better facilitate the financial modeling discussions that will be part of Phase 2.

**Discovery**
- Define project objectives and success criteria
- Review background and supporting data
- Assemble a Steering Committee to advise on the project
- Conduct stakeholder interviews
- Understand the current state, including strengths, areas of opportunities, and appetite for change

**Visioning**
- Draft a set of guiding principles to adopt as the foundation for future work
- Validate the current budget state through review of budget process and gain understanding of incentives
- Conduct analysis of the alignment between current and desired future state

**Delivery**
- Present findings and recommendations to the Steering Committee
- Develop a high-level budget redesign and implementation project plan
Developing the Model

Phase 2: Financial Modeling (10-12 weeks)
During this phase, Huron will take an iterative approach to develop a pro forma budget model using actuals financial data from UTK’s most recent fiscal year (FY2019).

- **Philosophy** – reflects the university’s desired financial management model, considering elements such as centralization, authority, accountability, and responsibility *(today’s discussion)*

- **Structure** – reflects the elements of the model with respect to scope of funds, categorization of operating units, presentation of data, etc.

- **Rules** – reflects how the model will portray the institution’s internal economy and drive behavior

- **Customizations** – reflects model tweaks to address operational realities, institutional culture, and local unit needs
Engaging University Stakeholders

Phase 3: Consensus Building (8-10 weeks)

Huron will meet with a multitude of stakeholders across the campus community to generate support for a new agreed upon budget model.

1. Engage Academic Deans and Business Officers

2. Involve Additional Stakeholders

3. Refine Pro Forma Budget Model
Supporting the Budget Infrastructure

Phase 4: Infrastructure Development (10 weeks)

Support redesign of budget processes and support elements that facilitate annual budget development.

**Stakeholder Training**
Identify opportunities to conduct stakeholder training related to the new model

**Process and Timeline**
Support the development of a revised budget development process that incorporates new activities and timeline constraints

**Unit Reports and Templates**
Work with budget managers and budget process facilitators to develop custom report templates and scenario planning models

**Governance**
Support the development of a governance plan that defines roles and responsibilities of stakeholders in the new budget process
# Shifting University Budgeting Focus

In order to optimize the benefits of effective planning and forecasting, universities are transitioning to a more strategic form of budgeting.

## Traditional Budgeting
- **Inventory** of anticipated expenditures
- Mechanism to **control** expenditures
- **Independent activity** performed by department managers
- **Backroom operation** performed by accountants
- **Spreadsheet** indicating resource availability
- Performance measures that **reset annually**

## Strategic Budgeting
- **Plan** for developing resources
- **Prioritization** of resource allocations for strategic initiatives
- **Explanation** of the internal economy
- Mechanism to create institutional **incentives**
- Tool to empower departments to engage in **entrepreneurial** activities
- **Predictor** of annual financial statements
- Baseline measure of **accountability**
Recent Budget Model Redesigns

Since the Great Recession, and with the continued strain on revenue sources, universities are undertaking comprehensive budget redesign initiatives with increasing frequency.

5 Primary Reasons for Budget Redesigns
1) Strengthen Allocation Methodology
2) Promote Revenue Growth
3) Drive Operational Efficiencies
4) Increase Transparency
5) Align Institutional Incentives

Note: This illustration depicts institutions who have undertaken a budget model redesign and does not reflect Huron-only budget redesign clients.
Overview of Budgeting Alternatives

Incremental budgeting is the most common approach to university resource allocation, though an array of alternative and hybrid models exists.

<table>
<thead>
<tr>
<th>Common Budgeting Models</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Incremental Budgeting</strong></td>
</tr>
<tr>
<td>- Centrally driven</td>
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<tr>
<td>- Current budget acts as “base”</td>
</tr>
<tr>
<td>- Each year’s budget increments (decrements) adjust the base</td>
</tr>
<tr>
<td>- Focus is typically placed on expenses</td>
</tr>
<tr>
<td>- Common modifications:</td>
</tr>
<tr>
<td>- Revenue incentives may be incorporated for the allocation of resources above-and-beyond the base</td>
</tr>
<tr>
<td><strong>Formula Funding</strong></td>
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<tr>
<td>- Unit-based model focused on providing equitable funding</td>
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<td>- Unit rates are input-based and commonly agreed upon</td>
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<td>- Annual fluctuations driven primarily by the quantity of production and not from changes to rates</td>
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<td>- Common modifications include weighting schemes to control for local cost structures</td>
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<td><strong>Performance Funding</strong></td>
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<td><strong>Incentive-Based Models</strong></td>
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<tr>
<td>- Focus on academic units</td>
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<tr>
<td>- Incorporates a devolution of revenue ownership to local units and allocates costs to revenue generating units</td>
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<tr>
<td>- Utilizes a centrally managed “subvention pool” to address strategic priorities</td>
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<td>- Common modifications:</td>
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<td>- Revenue allocation rules, number of cost pools and participation fee (tax rate)</td>
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It is very common to find institutions that are utilizing multiple budget models simultaneously, either as hybrid models or models to facilitate various university missions.

Note: Adoption rates from the 2017 Inside Higher Education Survey of College and University Business Officers; Percentages do not add to 100% due to hybrid budgeting models.
Spectrum of Incentivized Models

While incentive-based budgeting is commonly perceived as an entirely decentralized budget model, several incentive-based iterations exist.

<table>
<thead>
<tr>
<th>Incentive-Based Budget Model Iterations</th>
<th>More centralized</th>
<th>Less centralized</th>
</tr>
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</table>
| **Customized Incentive-Based Budgeting** | • A higher degree of central leadership control over resources  
• Local units keep most of their revenue but give up more than in the traditional incentive-based budgeting model through a higher subvention “rate” paid  
• Through increased subvention revenue, central administration has greater ability to subsidize colleges, fund strategic initiatives, and support mission-related programs  
• This iteration has been the most commonly implemented since 2005 | **Traditional Incentive-Based Budgeting** | • Some central leadership control over resources  
• Local units keep majority of the revenue they generate, but give up some to a central pool through a subvention “rate” paid  
• Rates generated can be used by the central administration to subsidize colleges, fund strategic initiatives, and support mission-related programs  
• These models were most frequently implemented from 1990 to 2004 |
| **Each Tub on its Own Bottom (ETOB)** | **Less centralized** | • Extremely de-centralized model; limited central leadership control over resources  
• Academic units essentially operate as their own financial entities  
• Very little strategic control held by central leadership (President, Provost, COO, etc.)  
• Under-performing units must cut costs or generate more revenue to cover any losses incurred  
• Only three U.S. institutions use this extreme iteration, one of which is shifting away |

In order to optimally tailor a budget model for a given institution, it is critical to identify and create an appropriate balance of centralized and decentralized control.
# Budgeting Alternatives: Pros & Cons

The use of hybrid models reflects the reality that each model comes with its own set of benefits and considerations.

## Common Budgeting Models

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<th>Performance Funding</th>
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<td>▪ Consistent treatment of budgets over time</td>
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<td>▪ Simple to understand and facilitate</td>
<td>▪ Uses readily available data</td>
<td>▪ Productivity data is used</td>
<td>▪ Encourages efficient operation of administrative service units</td>
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<td>▪ Provides equity across units</td>
<td>▪ Easy to understand</td>
<td>▪ Encourages planning</td>
<td>▪ Aligns revenues and costs</td>
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<td>▪ Maximizes central flexibility</td>
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<td>▪ Facilitates conversations about priorities</td>
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## Considerations

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<td>▪ Incentive to increase size, not increase quality</td>
<td>▪ Difficult to account for differences in quality of inputs and/or may sacrifice quality of outputs</td>
<td>▪ Requires strong central and local unit leadership</td>
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<td>▪ Needs periodic “re-basing” to ensure base does not become an entitlement</td>
<td>▪ Difficult to differentiate among local unit business models (e.g. student type, research)</td>
<td>▪ Poor performance may lead to a “downward spiral”</td>
<td>▪ Criticized for replacing academic with financial focus</td>
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<td>▪ Encourages spending to maintain budget</td>
<td>▪ Accounting for local unit factors increases model complexity</td>
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<td>▪ Without adequate transparency, academic collaboration hampered</td>
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Institutional culture, organizational complexity, mission, and systems capabilities are all factors that should be considered when determining a university’s optimal budget model.
Incentive-Based Budgeting

Incentive-based budgets are generally considered as models that incorporate the elements of revenue devolution, cost allocation, central subvention funding, and localized accountability.

<table>
<thead>
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<th>Description</th>
</tr>
</thead>
</table>
| Devolution of Revenue          | • Models devolve ownership of revenues from central administration to centers which generate them  
                                | • In particular: Tuition and fee revenues, direct research revenue, indirect (F&A) research revenues, and endowment and gift revenues  
                                | • The majority of models also devolve state appropriations based-on agreed upon methodologies                                                                                                                                 |
| Allocation of Costs            | • Optimal decision-making requires that the full costs of activities be understood, not just direct costs, but also those associated with facilities usage and central services provided  
                                | • An understanding of how indirect costs are allocated enables planners to estimate full marginal costs of proposed initiatives  
                                | • Each center pays for its total costs with the revenues it owns plus a share of centrally owned revenues                                                                                                                                 |
| Use of Subvention Pools        | • The provision of direct resources for strategic initiatives benefits the whole of the institution  
                                | • Allocations from central sources to responsibility centers called “subventions” are used to offset mission-critical units with high operating costs  
                                | • In part, this addresses the economic problem of the commons                                                                                                                                 |
| Financial Accountability       | • In exchange for devolving revenue ownership, the system requires bottom-line responsibility and rewards strong fiscal performance:  
                                |   • Centers retain positive operating margins and repay negative ones  
                                | • Financial accountability is a means, not an end in universities, and annual budget plans must still be reviewed and approved by university leaders |
Model’s Impact On Decision-Making

Incentive-based models have the potential to materially transform institutions over a 5-10 year period as they change the culture of decision-making.

<table>
<thead>
<tr>
<th>Chancellor’s Cabinet</th>
<th>Provost &amp; CFO</th>
<th>Deans</th>
<th>Administrative Units</th>
<th>Department Heads &amp; Faculty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remove luxury of “all things to all people” by forcing difficult decisions</td>
<td>Force clarity regarding priorities and strategic initiatives</td>
<td>Know full cost of activities (academic programs, research, etc.) and prioritize them through cross-subsidies between revenue generating activities and mission-driven activities</td>
<td>Connect service levels and resource levels</td>
<td>See how activities drive funding for their respective units</td>
</tr>
</tbody>
</table>
QUESTIONS?
APPENDIX
Huron Team Members

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MORE INFORMATION WILL BE FORTHCOMING ABOUT A BUDGET REDESIGN WEBSITE THAT IS BEING DEVELOPED BY UTK