



**QUESTIONS FOR EXCELLENCE:  
A BOARD GUIDE TO COLLEGE AND UNIVERSITY PLANS  
Essay 4**

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## **Asking About the Budget**

Board finance committees examine annual budgets with care and caution. Approving a budget means that the board is comfortable with the assumptions used to build the budget. Budget approval also means that the board has confidence in the skills of those guiding the computations (boards do not check calculations, but they do guide the hiring policies that bring in competent budget officers). Additionally, budget approval indicates that the board agrees with the priorities reflected in the budget's resource allocations and feels that there will be sufficient expenditure control to assure that those priorities are advanced.

Trustees should discourage several possible flaws that may creep into an institution's budget approval and implementation process: optimistic revenue assumptions, inadequate understanding of student responses to tuition increases, inertial rather than strategic resource allocations, and weak expenditure control during budget implementation. (See Chapter 6 on risk management for a related discussion.) While budget presentations should help trustees build familiarity with sources of revenues and the actions that consume resource, trustees must also examine the process of budget development and the procedures that bring the budget plan to reality. Many board crises have been precipitated by a flawed budget development process or by inadequate implementation. The questions in this chapter will help trustees monitor their institution's efforts to weed out flaws in the development process and improve the effectiveness of budget implementation.

These questions are commonly asked by finance committees. They request explanations of administrators' most important assumptions, including critical ideas about future revenues and about the responses of students to tuition increases. They also ask for explanation of the method for making allocations and the mechanisms of budget implementation.



## Revenue Estimates

Very few economic entities have strong control over the resources they take in. Steady financial performance, however, allows students (customers), faculty, and staff (employees) to focus on learning and teaching and not be distracted by rumors of decline and layoff. Colleges and universities try hard to exercise control over as many of their revenue streams as possible. This can be done with consistent annual fund-raising campaigns, fluctuation-smoothing rules for the drawdown of endowment earnings, and the encouraging of early admissions at “first-choice” institutions. Other measures include requiring large tuition deposits from new students and “banking” (placing into investment pools), rather than spending, bequests—a notoriously variable revenue stream.

Despite all precautions, many institutions find it hard to predict the number of current students who will return, the number of accepted new students who will matriculate, gift levels, endowment returns, research funding levels, and dormitory vacancies. The stock market goes up; the market goes down. Living in a residence hall seems fashionable one year, but in the next, students much prefer off-campus apartments.

Sophisticated revenue prediction makes use of all available information. Sophisticated institutions use careful policies (endowment spending smoothing rules, residency requirements) to limit revenue fluctuation. The questions below help trustees ascertain the depth of information and the quality of policies used by the institution to arrive at a revenue estimate.

*How have this year's year-to-date results changed our projected revenues?* In other words: Are we perpetuating last year's revenue estimation mistakes? While a college or university may err with an optimistic revenue prediction, it would be committing a much more grievous error by basing the following year's prediction on the current year's optimism. When actual results seem to leave substantial room for doubt that a revenue goal will be made, predictions for the following years must be moderated. Any revenue projection based on the previous year's goals must be supported by actual experience. Enrollments and gifts must be arriving at a rate that assures that the current budget will be met, before projections based on that budget can be proffered.



*How are revenue projections updated during the budget process?* In other words: Are we prepared for bad news on revenues? New information on enrollments, competition, the economy, and the stock market arrives all during the budget development process. The budget process should provide for regular revenue estimate updates, resource redeployment, and contingency-level adjustments as financial outcome clarity approaches with the coming end of the fiscal year. Trustees should anticipate that new information after budget approval might change revenue estimates and, should that change be significant, that budget adjustments have already been planned and outlined. This type of contingency planning should allow an orderly transition whether the news is bad or good.

*How large is the financial incentive for adding a new student?* In other words: What is the marginal return for an additional sale? It is crucial here that information be derived from the analysis of actual impact. For example, a rise in enrollments is not always financially beneficial. A larger cohort may require a major addition to student aid, higher expenditures in instruction, or a campus capacity expansion.

Institutions can calculate the changes in revenue and cost per student should there be an enrollment change of the largest probable size. The addition of a single student may result in few additional costs, but costs can change when enrollment varies at amounts “known to happen before,” especially over two or three years. The college or university should have identified those areas (even those job titles) in which a measurable, and possible, change in enrollment will require additional resources. The sum of the expenditures for all these “areas of response” divided by current enrollment gives a marginal cost (the change per added student). Most colleges have low marginal costs for normal enrollment increases. Many institutions with lower tuitions and responsive student aid programs have relatively low marginal revenues as well. An understanding of the net marginal contribution of an enrollment increase is important for setting financial strategies, short-term and long. Likewise, enrollment declines rarely lead to concomitant cost decreases. Careful research is needed to establish the financial impact of these marginal changes.



## Impact of a Tuition Increase

The positive financial impact of a tuition increase can be much less than the apparent gross increase. A \$100 increase for 10,000 students can bring in much less than the \$1 million that is produced by simple multiplication. Institutions committed to meeting all or some fixed proportion of student financial need with institutional scholarships find much of the anticipated increase in gross revenue disappears into financial aid. Each increase also forces students to compare the value of the institution with its cost. Some new students will decide not to enroll or to go elsewhere, while some continuing students may decide not to return.

When tuitions are increasing faster than inflation, the impact of these enrollment-reduction factors accelerates. Families are able to contribute shrinking proportions of support for students, while resistance to the increases escalates. Colleges whose mission directs them to serve many students with lower incomes already know that increasing tuition in the hope of generating revenue can actually become “revenue neutral” in its result. That is, increasing tuition can require increasing aid budgets and can shrink enrollment sufficiently to offset any prospective revenue gains.

The questions below help trustees assess the sophistication of a college or university’s analysis of the impact of a tuition increase. The institution should be able to demonstrate that it understands a family’s view of the impact and, thus, understands the full impact of its pricing policies.

*How much is the average student actually paying?* In other words: How much does the product really cost? The actual net tuition cost that a student must pay or finance (through loans) is his or her annual tuition charge less all forms of grant, scholarship, and discount support. To further understand this, consider the average “unmet need.” (For each aided student, unmet need is the amount remaining after the college or university’s aid packaging formula has been applied.) This amount shows how much of an average financial aid recipient’s cost of attendance is not supported by grants, subsidized loans, or the standard expected amount from a family’s income. Trends in this actual cost to the student as measured by both the average actual net tuition and by average unmet need are



usually at variance with trends in stated tuition price. Before authorizing tuition price and student financial aid policies, trustees should use this supplemental information to understand the true financial impact on student families of attending the college or university. These trends should be taken into consideration before raising tuition.

*What is the actual, current cash burden on students and their families?* In other words: What is the cash price? The cash price is what the average student actually pays out-of-pocket. After financing a portion of their schooling costs through loans and campus work, students still face an out-of-pocket tuition cost. This amount equals unmet need, as above, plus the formula-based expected family contribution. Monitoring trends in students' cash burden is important as well. Not having the necessary ready cash will keep anyone out of school. College and university leaders should have an understanding of the financial barriers presented by any upward trends in out-of-pocket tuition cost. If these pricing trends are negating the institution's enrollment strategies, then planners may need a new combination of financial strategies.

*What is our policy on tuition discounts?* In other words: How dependent are we on "sales through markdowns"? There are several trends that will shed light on this question. The trend over time in the proportion of students paying full or some minimum level of tuition after deducting college-financed grants, scholarships, and discounts may show that fewer students have the ability or desire to pay full tuition. Trends in the proportion of students supported by some form of a grant, scholarship, or discount from your college or university indicate changes in the financial effort necessary to get students to attend. Finally, the trend in the proportion of total non-need-based, institutional student financial aid to gross tuition revenue (gross tuition is the amount that would be billed before any grant or discount is applied) can show whether dependence on "markdowns" to attract students is growing. The higher the proportion of all forms of institutional student aid, the less an increase in tuition price will yield in new revenue.

*What happens to institutional financial aid budgets and enrollments for each percentage above inflation that tuition is increased?* In other words: Is raising tuition becoming



revenue-neutral? Each increase in tuition pushes most institutions' financial aid expenditures upward. Trustees need to know how quickly the student financial aid bite out of tuition revenue is increasing. A growing aid bite indicates that the institution will not be able to sustain itself with tuition increases for long. Each increase in tuition can also drive enrollments down (a condition economists call "non-zero elasticity"). A keen analysis of historical tuition and enrollment data is necessary to determine whether there is a link between the two. Enrollments may be examined directly or the yield rates of accepted students and retention factors may more accurately demonstrate how higher tuitions can affect enrollment.

### **Expenditure Allocations**

The following questions are expressions of concern at the policy level, not inquiries about specific allocations. Trustees would not usually be wise to ask specifically, for example, "Why did you give the English department a larger budget this year?" Rather, the questions should aim for an explanation of the budget process and express concerns over the quality of that process. Trustees should be shown how strategic direction has influenced the budget process. Trustees need to know how budgets are used to balance the need to "manage expectations" and reward creativity—opposing propositions. Trustees can track the integrity of the budget process by understanding how much of the budget is "locked in."

*How does the budget process align requests with strategies?* In other words: Is budgeting linked to strategic planning? The college or university's budgeting guidelines should require that each proposal for incremental funding be aligned with one or more strategic priorities. Officials giving budget presentations should be asked to focus on how the requested budget line items support strategic objectives. Most encouraging would be a demonstration that budget reductions are being made for strategic reasons, not just because the opportunity presented itself. The institution's response to this question may also include illustrations that the budgeting process has encouraged innovative thinking along strategic lines.



*How does the design of campus community participation in the budget process balance centralized strategic control against decentralized incentives for effectiveness and new ideas?* In other words: Who really makes allocation decisions? While not all college budgeting systems afford broad participation, trustees should encourage the goals associated with wide stakeholder involvement in decisions that affect them. College and university leaders should respond to this question by demonstrating that the budgeting process encourages “buy-in” to resource allocation decisions and that the process allows for tapping into the broad range of good ideas for resource use available on campus. At the same time, college or university leaders should be able to show how they have used the budget process to move the institution toward its vision using its given strategies. Moving an institution involves some element of control. Each college or university makes this balance in a different way. Administrators should be able to show that neither the extreme of authoritarianism nor the anarchy of laissez-faire administration dominates the process.

*How much discretion is there in setting budget allocations?* In other words: Is budgeting just an empty exercise? The proportion of the budget dedicated to items such as tenured faculty compensation, debt service, and lease obligations indicates the degree of relative inflexibility in the budget. An elaborate allocation process is hard to justify when a large, and perhaps growing, portion of the budget resists change. In high fixed-expense situations, allocation methods may be less interesting to the board than strategies for reducing expenditure inflexibility.

*How are faculty positions budgeted?* In other words: Should we regret authorizing all those searches? It is very difficult to initiate faculty searches long enough in advance of the start of the academic year to attract new faculty members of the best quality, while keeping the lead time short enough so that resources will be in place. Trustees should understand the risks in this process and the means used to hedge these financial bets. Colleges and universities track estimates of the normal rates of retirements, resignations, and non-re-appointments among faculty members and use this information in the



development of early, new faculty position authorizations—a large and critical element of the budget.

## **Expenditure Controls**

Budgets are written to convey detailed plans and policies, but the key to plans and policies is implementation. Budgets are implemented through effective communication, regular reporting, sanctions, approvals, and incentives. The following questions can help trustees understand how the budget they are examining will become reality. The quality of the process of implementation is of greater concern than the details of the budget.

*What are the sanctions when a department head overspends his or her budget?* In other words: Can people get away with ignoring their budgets? Before approving a budget, trustees should feel confident that the institution is effective at managing the budget. The institution's financial controls should keep expenditures in line with budgets. Nevertheless, sanctions must be appropriate to the ethos of the campus community. At many colleges and universities, obvious sanctions are inappropriate because no one would even think of spending above budgeted levels. College and university leaders should be able to demonstrate the effectiveness of whatever level of sanctioning they have found to be suitable.

*How do approval requirements change as the level of budgetary commitment changes?* In other words: Are all commitments, especially new hires, fully funded in the financial plan? This is a leading question. The hiring of a full-time person, with a probable commitment of resources well into the future, requires much greater scrutiny than the purchase of office supplies. The institution should be controlling such financially questionable practices as hiring a full-time person for the final portion of a year into a full-year slot budgeted at a part-time level. In these cases, the current year's restriction will be met, but the future commitment will greatly exceed the current burden. Budgeting for the purchase of capital equipment also is challenging. Purchasing policies must consider the initial cash drain, the ongoing depreciation charge, and the ongoing cash



drain of debt service. Institutional leaders must balance two conflicting principles: they must keep decisions close to those who know requirements best, and they must protect the college or university from debilitating financial commitments.

*How does our “early-warning system” work to project possible revenue shortfalls or expense-control problems?* In other words: How soon do we know we have a budget problem? A good response will demonstrate that the college or university has a means of regularly projecting expenditures and revenues, based on past experience with rates of expenditure outflows and revenue inflows. This system should provide warnings when individual budgets are headed for over-expenditure and should monitor overall budget balance.

*How is cash flow planning linked to revenue and expenditure projections?* In other words: Is cash being *managed*? Changes in expenditure or revenue patterns must be immediately incorporated into cash projections. Unforeseen budget changes have implications for solvency. An anticipated difficulty is more easily managed than a surprise.

*What incentives are there to spend budgets wisely?* In other words: How are year-end spending sprees controlled? In some institutions a portion of unspent budgets can be “carried forward” to the next year. While this discourages end-of-year spending frenzies, trustees should give a proportionate amount of scrutiny to the budget for “carry forwards” as they do to the regular budget. Underspensing a few departmental allocations does not ensure available funds in the next year for the college or university as a whole. The institution should have plans for how these extra allocations, if they are to be allowed, are to be funded: from reserves (perhaps built from underspent budgets) or from decreases to the budgeted surplus. Carry-forward budget policies should be part of the budget presentation to the trustee budget committee. Institutions that do not carry unspent budgets forward should be able to explain how they prevent last-minute buying sprees driven by the desire to consume remaining funds.



Budget presentations should help trustees build familiarity with sources of revenues, the actions that consume resources, the process of budget development itself, and the procedures that bring it to reality. Many board crises could have been prevented with a stronger understanding of revenue flows, expense drains, the process of creating the budget, and budget implementation.