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Carryforward Balances – Long Term Strategy
What steps and policies can be used to improve management of carryforward funds at UC Davis?

PURPOSE

The management of funds at UC Davis is decentralized and there is no uniform policy or guideline regarding the accumulation and management of carryforward funds. A more consistent and transparent approach is proposed to enable the campus to provide better information about its carryforward balances, as part of our accountability and stewardship to students, the citizens of California and others who fund university operations.

The 2012-13 and 2013-14 annual budget meetings included discussion of the rationale and planned uses for the carryforward funds within the schools, colleges, divisions, academic support and administrative units. However, without guidance about best practices, units have taken different approaches to managing these funds. This paper is intended to establish some standard guidance for the management and review of carryforward balances on our campus.

DEFINITIONS

Carryforward balances (or carryforward funds) are unexpended balances at the end of the year. Generally these balances are calculated as: current year budget appropriation and prior year balances less current-year expenditures. For self-supporting, auxiliary and other revenue-generating activities, carryforward balances are calculated against actual revenue generated. In many cases, there are planned uses of the funds, but these uses are not reflected in this calculation.

Legal encumbrances (also called external encumbrances) are generated by the purchasing system when a purchase order is approved and reflect a contractual obligation by the university to expend funds.

Pre- (formerly departmental) encumbrances reflect a unit-level commitment to expend funds. In some cases, such as approved faculty start-up costs, there is a written document describing the commitment. In other cases, the pre-encumbrance represents a planned expenditure that can be changed or cancelled at the local level.

Reserves are a specific fund category recognized in the accounting system and generally used for self-supporting, auxiliary activities or campus-based student fees. These are funds set aside for a specific and future use and typically fall into one of two categories: reserves for equipment and reserves for improvement. Equipment reserves are established using a standard depreciation schedule, whereas improvement reserves are set aside as part of the budget planning process for that activity and are generally more subjective.

Core, Fee and Other Unrestricted Funds are defined as general funds and tuition, summer session fees, professional degree fees, student services fee, course material fees, campus-based and other student fees, indirect cost recovery revenues, private unrestricted gifts, unrestricted endowment/FFE earnings, University Extension reserves, self-supporting degree fees, application fees and other funds which include primarily short-term investment and patent revenues.

Short Term Investment Pool (STIP) is the interest earned on aggregated cash balances that are managed at UCOP as a single pool to generate interest income. Interest income is distributed to the campus at the end of each quarter based on average monthly balances. The actual allocation of STIP is set by various OP and campus policies. When any fund group has a negative cash balance, it is netted against campus cash balances and thereby reduces the STIP earned and distributed (negative STIP).

BACKGROUND

Existing Policies and Practices

While the campus does not have a uniform policy regarding carryforward balances, there are several policies and practices in place as described below.

- Rate activities (Policy 340-25). The detailed guidelines for rate activities indicate that units should manage operations so that year-end balances are within 8.3% (30-days) of annual revenues. Any amounts that exceed this threshold are to be resolved within three-years and resolution is considered as part of the rate review process.
- Gift and endowment funds. The university has an important stewardship responsibility to its donors to ensure funds provided are used. Periodically, reports about unspent balances are provided to deans and vice chancellors for review and distribution to departments.
- Extramural funds. Guidelines vary based on agreements with sponsors.
- University Student Aid Program (USAP). There is a long-standing systemwide policy that carry-forward of USAP funds not exceed 10% of the annual appropriation.
- Funds and activities with long-term debt obligations. There are some activities that must demonstrate annual operating surpluses consistent with long-term obligations. These policies have shifted over time, but in general, there has been an expectation of debt coverage of 125% (i.e., annual operating revenues exceed annual operating expenses by a factor of 1.25).

The financial system does not impose any system-level controls so adherence to the policies and practices denoted above is generally left to the departments with some periodic oversight by a central office (i.e., BIA, Accounting & Financial Services, or Development).

How are carryforward balances (funds) generated?

Core state and tuition fund (19900) carryforward balances are usually the result of salary savings from unfilled faculty or staff positions. In many schools and colleges and in some administrative units, salary savings are used to meet a structural component of the budget called the "Budgetary Savings Target (BST)". The BST was implemented in the early 1990's to recognize that there is a certain level of vacancy that occurs for all positions. The BST essentially anticipates salary savings so when savings do occur they cannot be used for other purposes. However, if savings from vacancies exceed the BST or if units have permanently implemented cuts to eliminate the BST, salary savings accumulate as carryforward funds.

In the case of a rate or fee-based activity, a carryforward may result from higher-than-anticipated revenues without a corresponding increase in expenses, or balances can also result from salary savings (same as above example) or because the assumptions used to calculate the rate were not correct. Finally, it may be that anticipated expenses did not occur or a more efficient or cost effective option was available.

For other unrestricted funds, particularly during periods of budget uncertainty, most take a very conservative approach to spending, often deferring or cancelling various expenses to ensure that carryforward funds are available to bridge or mitigate budget cuts. Further, many accumulate funds as part of a multi-year financial strategy to fund large, periodic or multi-year expenditures such as start-up packages for new faculty, equipment or multi-year support packages for graduate students.

Rationale for and use of carryforward balances

Accumulation of carryforward balances is considered to be a prudent, fiscally responsible management practice. As noted above, there are many examples of commitments made over a multi-year period (e.g., start-up funds for a faculty position, reserves for equipment/improvement, a new program or graduate student support). As such, there is a strong rationale to accumulate funds to meet the full commitment in advance to avoid any disruption. Carryforward funds also mitigate risk, which is common with various university funding streams such as unrestricted state support or various extramural funds.

Recent campus consultation has confirmed that carryforward funds are relied on to manage financial risk, including gaps in between federal grants, cost increases and fiscal uncertainty. Any campuswide strategy should recognize the need for organizational flexibility to manage these risks within the specific context of programmatic and operational constraints.

DISCUSSION

Range of Approaches to Consider

Based on an August 2012 report prepared by the Education Advisory Board[1] and additional research into how other universities manage their carryforward balances, it is clear that a variety of methodologies are used. These are categorized into a scale ranging from highly decentralized (A) to progressively greater central campus involvement/specificity (F):

[1] Moore, S., and Salaman, M. "Calculating and Communicating Carry Forward and Reserve Policies." *Education Advisory Board*. Aug. 2012. http://www.eab.com/Research-and-Insights/Business-Affairs-Forum/Custom/2012/08/Calculating-and-Communicating-Carry-Forward-and-Reserve-Policies

Approach	Methodology	Description
A	Unit Held and Used	Units accumulate and use carryforwards/reserves at their discretion
B	Central Campus Review	Carryforward amounts reviewed centrally and assessed for "reasonableness"; no prescribed limits or further policy set
C	Spend Down	Options seen at other institutions: - full/partial spend down expected in the next year - full/partial spend down prior to asking for additional central funds
D	Levy (tax/holdback) Applied	A central campus levy or holdback e.g., 3%, 15%, 25%, 85% applied on carryforward balances
E	Percentage-Based Limits	Specific %-based limits established (e.g. 0.2%, 2%, 2.5%, 3%, 5%, 10%) and applied on an account, fund type or budget basis by unit
F	Absolute Limits	Pre-determined dollar limits established (e.g. $10k, $25k, $50k, $100k, $150k, $300k) and applied on an account, fund type or budget basis by unit/college. Approaches E and F can also work in combination

How other campuses have approached this issue has likely depended on the size, culture and constraints faced. For example, a small campus with highly centralized financial controls may be more likely to be further down the spectrum. In addition, an important driver often noted is the impact on student tuition and fees related to the amounts of allowable carryforward.

At UC Davis, we have historically taken Approach A, although there have been specific situations where units were requested to spend down carryforward funds as part of the annual budget process or in response to a particular funding request. In considering a longer-term strategy for UC Davis, some key issues to consider are the following:

- current and future campus fiscal situation
- impacts on students and their fees
- central campus and unit needs and flexibility
- the new budget model/process

Approach B, combined with general guidance about best practices, may better meet the collective needs of the campus. With respect to guidance, a range of 10-15% (roughly 30-60 days cash) is suggested for funds managed through the campus budget model and for all student fees. **For other funds such as indirect costs, patent funds, application fees or other unrestricted funds, it may be reasonable to consider a larger margin such as 90-days cash or about 25%.** These ranges reflect reviews of other university practices, input from various campus constituents, as well as considerations related to risk management and campuswide expectations/culture. As an example, moving to a 25% margin for some funds recognizes that there may be a higher degree of volatility or necessary flexibility in their use. The "right" approach for campus weighs many of these considerations, and we expect to continue to learn and evolve how we manage our carryforward balances over time.

Under this approach, the Provost would receive carryforward data as part of the annual budget process discussions. When a unit's prior year carryforward in core and other unrestricted funds (as defined above) exceeds the guideline based on prior year expenditures, a rationale or spending plan would be required to be included with this data. Conversely, if below 10% of prior year's expenditures, a savings plan would be required. BIA would also conduct a mid-year review of these plans with units, likely in the Fall. Units operating within the guideline would not need to submit any rationale or spending plan concerning their carryforward as a part of their annual budget process.

Further, the campus would benefit from information in our financial system to better record future commitments. Specifically, in addition to identifying formal legal encumbrances, it would be a good practice to identify budget commitments that have formal executive level approval (e.g. Dean, Vice-Chancellor, Vice-Provost sign-off). To better track commitments, definitions were developed and piloted as part of the 2012-13 fiscal close process. A specific object code (COBL) was created to easily record the "committed obligations" or hard commitments that restrict the use of funds for other purposes and may be legally binding. For instance, start-up funds that have been committed to a specific faculty member in a formal, approved offer letter could be coded COBL for the initial term (usually three years). A separate type of obligation, "known obligations" with corresponding object code (KOBL), was implemented to record potential expenditures such as savings for a future faculty start-up. Any obligations will need to meet these new definitions to be coded as COBL or KOBL, with adequate supporting documentation and approvals in place.

Evaluation of carryforwards would reflect total amounts as well as amounts adjusted for the commitments (COBL and KOBL) to enable a better understanding of the magnitude and expected use of these funds over time.

An important goal of this approach is to provide flexibility at both the central campus and unit levels to report and describe carryforward balances. And, while the guideline provides upper and lower targets for carryforward funds, it does not dictate a more formal or centralized mandate with regards to these funds. It does imply that further discussions and possibly management decisions about these funds will follow with specific units that surpass the ranges.

Including core, fee and other unrestricted fund types in this review recognizes our accountability and stewardship responsibilities, as well as the varying levels of capacity that units have to fund their activities across multiple fund sources. Some units may be highly dependent on state funds and tuition while others may have a greater diversity in funds that support their operations. As state funds and tuition become a smaller share of the university's total revenues, we must move towards an all-funds approach in how we fund all our operations.

Related Carryforward Balance Issues

Consistent with this approach on core, fee and other unrestricted funds, campus is also considering a change to the self-supporting rate development/review process, which would move from the currently allowable carryforward of 8.3% of revenues to the recommended 15% range. This change would make the expectation for self-supporting funds consistent with that for other funds. Note: Adherence to federal regulations and guidelines enables "working capital reserves" of up to 60 days for cash expenses for normal operations incurred for the period exclusive of depreciation, capital costs and debt principal costs, and will continue to apply as it currently does.

In addition, evaluation of the generation and allocation of STIP (Short-Term Investment Pool) is an important part of the incentive structure for carryforward balances and reserves. Currently, when there are positive balances, STIP interest revenue is generated and accrues back to specified funds (see UC Davis PPM section 330-06). However, interest charges against negative balances (negative STIP) have historically been absorbed by the Chancellor's Investment Fund. The campus will consider changes to assign STIP revenue, whether positive or negative, in a more consistent process to ensure greater alignment and accountability in treatment across all carryforward balances.

RECOMMENDATIONS

Provide the campus with guidance that 10-15% or 25% is a prudent goal for carryforward balances in most major unrestricted fund categories discussed in this paper. The annual budget process will consider carryforward funds as follows:

- If balances in core, fee and other unrestricted funds exceed 15% of prior year expenditures, deans and vice chancellors will be asked to provide a rationale or spending plan for balances during the annual budget meeting. The coding in the accounting system using COBL and KOBL will highly inform the discussion. In addition, modest balances in individual faculty research accounts would not require a detailed spending plan.
- If balances in other unrestricted funds such as application fees, indirect costs, patent funds and other funds[2] exceed 25% of prior year expenditures, deans and vice chancellors will be asked to provide a rationale or spending plan for balances during the annual budget meeting. The coding in the accounting system using COBL and KOBL will highly inform the discussion.
- For balances in core general funds that are less than 10%, deans and vice chancellors will be asked to propose a savings plan or revenue generation strategy.

In general, it is assumed that the ideal goal of 10-15% or 25% will be managed as part of a multi-year budget planning process of up to three years. Policy changes will also be made to the self-supporting rate development/review process (moving from 8.3% of allowable revenues to 15% of expenditures).

TECHNICAL IMPLEMENTATION NOTES

BIA will continue to partner with Accounting and Financial Services to establish the carryforward calculation methodology, a standard reporting outline at the Dean/Vice-Chancellor level (organizational level 4 or 5) and sub-fund group type, as well as other implementation steps as needed.

Likewise, BIA will also work with the Office of Development in reviewing endowments and funds functioning as endowments, and potentially other fund types, to provide more of an "all funds" view of campus finances.

[2] Other funds include: retirement of indebtedness, loan funds, plant, 68700, 69250-1, 69240, 69763-4, 68800, though is 90% STIP and patent revenue on a campuswide basis.

Guidance based on additional analysis and campus consultation has been developed to address questions and comments raised on version 1 of this white paper, including recognizing both committed and known obligations, incorporating flexibility in relation to the carryforward margins at subordinate organizational levels and balancing workload considerations with campuswide responsibilities for accountability and stewardship. It also outlines procedures and a reporting format to ensure that information and timing expectations are clear.

A section that expands on the potential management decisions that could result based on this information has also been included. While in 2012-13 there was a mid-year budget realignment process that considered carryforward balances, the Guidance document confirms that the procedures developed will provide campus with better information to be able to consider a range of potential outcomes – for example matching/cost-sharing specific activities/programs or advancing high priorities through redirecting use of carryforward funds. Further steps towards a more incentives-based approach will also be considered as the campus improves its fiscal position.

While campus is outlining a more consistent and transparent approach through this strategy, as greater experience is gained, it will be important to review and refine this approach to carryforward balances over time.