RIGHT
ADVISORY

1101 30th Street, NW, Suite 500
Washington, DC 20007
Main: 202.625.8356 • Fax: 202.625.8359
www.rightadvisory.com

Article by Robert M. Tarola, CPA, CGMA
President - Right Advisory LLC

Traditional Higher Education – A Challenged Value Proposition

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This article from Right Advisory LLC is based on knowledge gained and opinions formed during a multi-year engagement as a contract chief financial and chief administrative officer of a major US-based international research university and health system. The challenges to balance budgets, delight students, encourage faculty, satisfy supporters and meet societal objectives were top-of-mind and constant subjects of discussion. Although similar discussions around similar subjects occur in the commercial world, the systems to make decisions and take action are much more advanced. Moreover, seldom was the discussion focused on the value proposition – it was most often focused on parochial interests of faculty, staff and alumni. This article will outline the systemic challenges to improve the value proposition faced by many traditional universities and ways they might be addressed.

Executive Summary

There is much criticism levied on higher education – poor outcomes, high administrative costs, high student debt and low graduation rates - to name a few. The value proposition seems ill defined and could indeed vary by institution and constituent. There are structures and tactics used by successful commercial businesses that could be adapted by universities to improve the value proposition and chances of future success. We explore those themes below.

First, let's look at the higher education industry – it is no doubt under significant resource pressure and technological change. Gone are the days of simply raising prices to cover rising costs. Bricks and mortar settings and teaching silos are being replaced with online courses and collaborative learning structures. It is an industry under aggressive renewal. It is an industry ripe for consolidation. Commercial industries similarly situated include healthcare, banking and most professional services. The value proposition to society would improve with fewer but better universities.

Now let's look at the business model – as a professional services business, the higher ed design is inverted compared with the commercial model. There are far too many owners (tenured faculty) compared with workers (support faculty). This is an inherently "low leverage" model. Consequently, the model has little ability to promote productivity causing inflation to be transferred to customers – which is an unsustainable negative factor in the value proposition.

Next, financial management – too few universities have embraced modern systems of accountability and transparency. Long-employed accounting and accountability structures in commercial businesses are often counter-cultural – and raise strong dissent; depriving the university of significantly improved decision-making support. Lack of accountability makes providers of money very cautious – lowering the absolute amount available and increasing the cost – which are two more negative factors in the value proposition. And the payment system relies too heavily on student loans – making the college degree a financial burden for years beyond graduation.

Finally, governance – many universities are dependent on taxpayers for support. In exchange for money, the state (or other political entity) requires universities to be governed by political appointees. Even the boards of private universities tend to be political and larger in number than most any business enterprise. Couple the complex board structures with shared governance provisions, and you have a system that makes for very slow decision-making and often dysfunction. The competitive environment will not wait for boards to reach consensus – especially when consensus means unanimous. A much more nimble governance structure (public companies do it with an average of nine directors) will have to evolve for traditional institutions to remain competitive and enhance the value proposition.

The Higher Ed Industry – Ripe for Consolidation

As noted above, the higher education industry is under severe scrutiny from legislators, regulators, payers and users. Everyone is asking about the value proposition. Unfortunately, there are no "generally accepted" standards for assessing value. In fact, list price has become a proxy for value – even though very few students actually pay list price. And the ability to collect list price becomes more doubtful as each year passes. At the same time, costs keep rising – a factor of general inflation and an upside-down business model. We will address the business model later. For now let's look at the economic factors of supply and demand.

It is fair to say that there is stress in the industry. It is no doubt under significant resource pressure and technological change. The question is whether traditional institutions will find a way to consolidate and share resources to compete with the emerging educational models, or struggle at going-it-alone until they have no choice.

As largely a tax-exempt industry, the traditional institutions already receive high indirect taxpayer subsidies – and most receive direct subsidies as well. Yet many can still not make ends meet. The allocation of resources needs to be rethought to achieve a better balance of opportunity and investment. There is far too much supply for the demand.

The challenge (and impediment) to a more efficient use of resources is the "tradition" in the traditional university. No other industry has "graduates" with so much influence. Graduates tend to think of themselves as continuing owners – partly because of the emotional bond to alma mater and partly because of the brand value that they ascribe to their life accomplishments. Despite those strong connections, however, only a few elite schools can pay the bills on alumni support and tuition alone. Most will continue to need taxpayer subsidies.

This begs then for industry changes that will allow for a more effective use of taxpayer money. Some of the changes that should be considered include: combining institutions to achieve educational and administrative synergies; moving investment from hard assets to soft assets rewarding those who innovate; replacing the tenure model with a performance driven reward system; and, allocating taxpayer resources more equitably among students. Why should Mary get $x, while Jane gets $xx, and Jack get $none? By whom and from where are those value judgments being made with taxpayer money?

The Traditional Business Model – An Unsustainable Tradition

Now let's look at the traditional business model. As a professional services business, the higher ed design is inverted compared with the commercial model. There are far too many owners (tenured faculty – the rainmakers) compared with workers (support faculty – the troops). It is an inherently "low leverage" model – about 2-3 support faculty for every tenured faculty member. A commercial professional services business would be closer to 10 troops for every rainmaker. Consequently, the model has little ability to achieve productivity gains - causing inflation to be transferred to customers. Commercial businesses would adjust the number and experience level of support professionals to balance career aspirations with cost control. The inability to adjust employment mix, and related cost, is the main reason for stress in the model when pricing becomes inelastic – as it has been since at least 2008.

There are two main levers of productivity in the traditional higher ed model – student/faculty ratio and the level of funded research. Being low on both measures is a recipe for distress. Being high on both measures creates financial flexibility and options for the institution. There is also the cost of administration, which must always be driven to a lower percentage of revenue.

Let's start with student/faculty ratio. For the most part, this metric defines an institution. Is it high-touch (single digits to 1) or high-volume (high teens/low twenties to 1)? At high-volume, the cost structure per student is generally low and the leverage factor is generally high – creating flexibility when needing to address financial challenges. It is just the opposite for high-touch institutions. The lower the student/faculty ratio, the harder it is to cover cost inflation with productivity gains. Consequently, cost increases must be passed on to students - straining the value proposition. At some point – many would say it is now – higher prices for the same outcomes cannot be justified, causing lower demand. The lower demand starts a bottom line crisis that can only be addressed with cost cutting – always difficult in traditional higher ed.

Is research the silver bullet? It could be! The profit from funded research can cover a lot of imbedded cost. This is another form of leverage - where the fixed costs of buildings and faculty are used to produce more dollars. A high-touch institution with a high research mandate can, in many cases, blend the best of both to offset higher costs from inflation. This allows for increased competiveness on the value proposition.

Administrative functions are also leverageable. The cost to deliver high quality services can be minimized by deploying techniques long-used by commercial businesses. Techniques such as standardization, automation, consolidation and integration ("shared services") are ways to save money and improve effectiveness. No institution can justify high admin costs as part of the value proposition.

The market place will ultimately insist on a sensible balance of cost and value. It will take a partnership with faculty to push productivity toward research and larger classes, and accept a more efficient administrative model. Those partnerships are often difficult to forge – but not doing so could mean unsatisfied careers and customers. The institutions that can offset inflation with productivity gains will be sustainable. The ones that cannot – will not.

Financial Management – A Call For Modernization

Too few universities have embraced modern systems of accountability and transparency. Long-employed accounting structures in commercial businesses are often counter-cultural in universities – and the opportunity cost can be substantial. But more importantly the transparency, controls and timeliness achieved through modern financial management systems can significantly improve decision-making.

When university CEOs and CFOs try to employ modern systems of accountability and efficiency, they are often met with strong cultural objection from the academic side – the University of Michigan, University of Texas and Howard University are three recent public examples. As a result, universities pour money into the status quo – supporting the unsustainable business model. A transition has to occur, and will ultimately occur. The question is whether it will be a managed transition while there are still financial reserves to cushion the change, or a forced transition as financial reserves are depleted.

There is a sad misimpression among some academics that "if only the endowment were higher," financial problems would be solved. Sure, a larger endowment can throw off more cash for operating support. But, to a very high degree, the endowment is restricted as to use and cannot be deployed for general purposes, which change regularly. Moreover, the annual draw on the average endowment is relatively low (about 5%) and thus usually covers only a small percentage of annual operating costs. So – although no one wants to give up hope, the endowment is not a realistic source of growth capital or inflation offsets.

Complicating higher ed financial management is the convoluted way tuition and fees are paid. The system of government and private loans is complex and is causing students and families to assume substantial obligations – even before they know if the student will have a degree to exploit in the future. And the loan levels are growing as students take five and six years or more to graduate. Moreover, nearly half of the future obligations are for loan money that never went to the university – it was used for other purposes determined by the student. So, when you hear that student debt is high, please note that a large percentage of the borrowing is for extra years to graduate and for living expenses, rather than university charges. Therefore, bringing down student debt is at least an equal measure of matriculation management as it is cost control.

Innovations and incentives such as those being implemented by Temple University need to be explored across traditional higher ed. Carte blanche debt forgiveness, the seemingly current government solution, will only encourage poor borrowing behaviors and make matters worse.

Finally, let me address the culture of non-accountably. Traditional higher ed is run like the federal government – employees spend the money and leaders must raise the money. Almost no university holds faculty accountable for revenue – or to manage a bottom line. Consequently, revenue stress is often seen as an administrative problem, and not shared by the academic community. The financial issue is almost always perceived as not enough revenue. The problem is seldom seen as an unproductive and/or inefficient cost structure. Unfortunately, the ability to raise prices indiscriminately is over. Sound financial management will require robust cost control and accountability. Managing to the bottom line must become a shared accountability.

Shared Governance – Requires Shared Responsibility

A board of "constituents" often governs a university. The board could include political appointees, faculty appointees, student appointees and alumni appointees. These complex board structures, with shared governance provisions, make for very slow decision-making and often dysfunction. The competitive environment will not wait for boards to socialize every decision and seek buy-in before making a move. A much more nimble governance structure will have to evolve for traditional institutions to remain competitive.

Universities are businesses that have fiduciary obligations to taxpayers, lenders, investors, donors and workers. The complexity of these obligations requires sophisticated operational and functional expertise on the board – similar to a publically traded company. The tendency to favor constituents, who may have little experience running a complex enterprise, can often render the board ineffective as a fiduciary body. The desire for constituent fairness can result in inaction, retractions and suboptimal institutional decisions. Note the much-publicized reversal of board decisions at the University of Virginia after faculty objection; bringing into question fiduciary accountability.

Universities should follow the governance requirements and principles of listed companies. Like listed companies, universities often use public money and finance activities with public debt. The fiduciary obligations to the public are no different yet they can get pushed aside by constituent interests. As the Securities and Exchange Commission ratchets up its enforcement of university bond issues, best practices in governance will be expected. And those best practices are well established in securities regulation and law.

A university bond issuer with a constituent board would be well served to name a subset of board members, familiar with securities law and obligations, to make fiduciary decisions that affect outside interests. This "fiduciary board" would be charged with decisions and oversight of obligations and commitments to outsiders who provide funding or capital – governments, bondholders, donors, banks and investors. The full "constituent board" can continue to make decisions and oversee how the university is meeting its mission. However, the accountability for balancing the mission with the money should be clearly delineated.

Finally, a word on shared responsibility. When a board contains constituent representatives, it is imperative that such board members act in the best interests of the university. This is easier said than done because, for the most part, these members are appointed or elected by their constituents. A healthy governance structure and operation will find a way to take the best information from constituent members while at the same time ensuring they serve with accountability to the institution. The future sustainability of traditional universities will likely depend on being nimble and innovative – and competition does not wait for unanimous decisions at the board level.

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The outline above describes the themes that Right Advisory LLC believes boards will have to address as they position their institutions for the future of higher education. Each theme will have different attributes and aspects for each institution. A strategy tailored to the specific value proposition of each university would have to be developed.