

## Carryforward Balances – Long Term Strategy

### *How should UC Davis manage its carryforward balances?*

#### 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. The 2012-13 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 very 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. For most units, these balances are calculated as: current year budget appropriation and prior year balances less expenditures. For self-supporting, auxiliary and other revenue-generating activities, carryforward balances also include revenues.

*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* are created locally in the system and 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 accumulated following a standard depreciation schedule for equipment being replaced, whereas improvement reserves can be more subjective.

*Core and Other Unrestricted Funds* are defined as state funds and tuition, professional degree supplemental tuition, self-supporting degree fees, student services fee, other student fees (excluding course materials fees and referendum-based fees), summer session fee revenue, indirect cost recovery revenues, private unrestricted gifts, and University Extension reserve funds allocated to units (Fund 75090).

**Short Term Investment Pool (STIP)** is a cash investment pool available to all UC fund groups. Cash balances are aggregated with all UC cash balances and managed at UCOP as a single pool and generates interest income. This interest income is distributed at the end of each quarter based on average monthly balances. STIP allows fund participants to maximize the returns on their short-term cash balances by taking advantage of the economies of scale of investing in a larger pool. When any fund group has a negative cash balance, it is netted against campus cash balances and thereby reduces the STIP 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.
- 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%.

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 can accumulate to generate 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 approach or a more cost effective option was available to meet the needs supported by this fund source.

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, but periodic expenditures.

### Rationale for and use of carryforward balances

Accumulation of carryforward balances is considered to be a prudent practice. 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.

## DISCUSSION

### Range of Approaches to Consider

Based on an August 2012 report prepared by the Education Advisory Board<sup>1</sup> and additional research into how other universities manage their carryforward balances, it appears there is not “one way” all campuses approach this issue. 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):

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

<sup>1</sup>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>

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.

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

As a matter of practice, moving to Approach B, combined with general guidance noting a 10%-15% margin (up to 60 days allowance), may best meet the collective needs of the campus going forward. Under this approach, the Provost would receive carryforward data as part of the annual budget process discussions – similar to the 2012-13 budget process. When a unit's prior year carryforward in core, reserve and other unrestricted funds (as defined above) exceeds 15% of 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 10%-15% margin would not need to submit any rationale or spending plan concerning their carryforward as a part of their annual budget process.

Carryforward balance calculations would recognize specific and known future commitments and would therefore exclude the following: legal encumbrances, reserves for equipment/depreciation, and a sub-set of pre-encumbrances that have formal executive level approval (e.g. Dean, Vice-Chancellor, Vice-Provost sign-off).

For this sub-set of pre-encumbrances, a clear definition will be developed, along with a specific object code to easily separate these from other pre-encumbrances. In essence, these pre-encumbrances must be considered 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 excluded for the initial term (usually three years). However, funds set aside for a potential faculty hire would not be excluded. A similar distinction is made in relation to reserves for equipment (RFE) and reserves for improvement (RFI). RFEs are accumulated for specific equipment purchases, supported by a standard depreciation schedule, whereas RFI are softer commitments. (Notably, RFI cannot be charged to federal contracts/grants.) An exhaustive list of exclusions will not be developed, but any pre-encumbrances will need to meet this new definition, with adequate supporting documentation and approvals in place.

While this subset of pre-encumbrances will not be included within the 10%-15% margin calculation, it will be reported separately, and reviewed during the annual process, to enable a better understanding of the magnitude and expected use of these funds over time.

This approach continues to provide significant flexibility at both the central campus and unit levels. While it provides a 10%-15% marker 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 15% marker.

Including core, reserve and other unrestricted fund types in this review recognizes 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, reserve 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 a 10%-15% margin on expenditures. This would make the expectation for self-supporting funds consistent with the guidance provided for other funds. Note: Adherence to A-21 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, campus is considering changes to how STIP (Short-Term Investment Pool) interest earnings are distributed in relation to fund balances – to keep these earnings aligned to units who receive these funds. 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) has historically been absorbed by the Chancellor's Investment Fund. Changes will be proposed 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.

### **RECOMMENDATION**

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

- If balances in core, reserve and other unrestricted funds exceed 15% prior year expenditures, deans and vice chancellors will be asked to provide a rationale or spending plan for balances during the annual budget meeting.
- For balances 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% will be managed as part of a multi-year budget planning process that covers three years (i.e., the ideal level of 10%-15% should be achieved within a three-year planning cycle).

Linked policy changes will also be made to the self-supporting rate development/review process (moving from 8.3% of allowable revenues to 10% -15% of expenditures), and transferring both positive and negative STIP balances to receiving units.

BIA will continue to work 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.