

Building on the past: A new approach to higher education finance

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to help transform its culture



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Vanderbilt University Chancellor Nicholas Zeppos recently reviewed all of his predecessors' notes to get a feel for the last time the institution confronted a similar level of macroeconomic volatility. His conclusion? The early 1930s.

"That's the last time you see similar discussions of large cost cuts, endowment drops and widespread unemployment," notes Zeppos, who asserts that large U.S. universities have grown much more complex today, a factor that exacerbates current challenges posed by the tough economy and tight credit markets.

How has Zeppos addressed a set of challenges never experienced by the current generation of U.S. university leadership? By taking a leading-edge approach in reorganizing Vanderbilt University's finance function. The university replaced a largely decentralized financial management model with a centralized CFO's office that oversees all of the university's finance and accounting strategies and activities. This includes the Schools of Medicine and Nursing and wholly owned hospitals and clinics, in addition to the University's eight other schools and colleges.

The implementation of a stronger, centralized finance function represents a step in Zeppos' ongoing effort to develop a "one-university" culture that embraces a collaborative approach to executing its mission of being one of the greatest educational institutions in the world.

A stronger, more focused and centralized finance function represents a cornerstone of the one-university culture – one that will help ensure that the entire university operates in a collaborative manner to identify financial risks and opportunities through more effective financial, budgeting and financial risk management processes.

The change also transformed the university's highest-ranking finance role, a newly defined CFO position now occupied by Brett Sweet, who was hired earlier this year as part of the finance restructuring.

Under the previous finance function model, the university's top finance person had a much broader administrative role and a shallower set of finance responsibilities – akin to a CFO of a holding company who handles the consolidation of financial information from different academic and healthcare segments of the university but who does not possess the lines of sight or the authority to advise on, and help make, budgeting decisions across the university. While Sweet favors a strongly collaborative approach to providing his colleagues throughout the institution with fact-based financial support and advice, his position possesses the authority to make budgeting decisions on behalf of the entire university. To be sure, Sweet emphasizes that his role is not to triumph at will over academic decisions that involve financial matters. Rather, his responsibility is to work with his academic counterparts to strike the delicate balance of generating a return on mission along with a return on investment.

This shift represents one of several notable changes to the CFO role under Vanderbilt's new finance model (see "New Structure, New Role" side bar).

Zeppos believes that the new reporting lines will give the institution three primary advantages at a time when capital is much more difficult to come by:

- Greater visibility into investments in infrastructure, capital and academic programs;
- Stronger financial risk management capabilities; and
- More "fact-based" and forward-looking capital allocation decision-making capabilities.

Or, as Zeppos puts it, "We will be better at meeting our mission, and therefore we will be a better university."

Like all U.S. research universities, Vanderbilt's straightforward and noble mission – addressing the full scope of humanity through education, research, discovery, and in Vanderbilt's case, patient care

(through its medical center) – has grown increasingly challenging and complex. Delivering on the mission hinges on a tangle of factors: the endowment’s role in the overall financial strength of the institution; federal healthcare budgets; National Institutes of Health (NIH) and National Science Foundation (NSF) funding; the ongoing status of a state Medicaid program; and financial models for financial aid plans, to name a few.

New Structure, New Role

In replacing a decentralized finance function with a centralized finance model, Vanderbilt University also overhauled the role of its highest-ranking finance executive. This chart highlights the differences between the role of Vanderbilt’s top finance position before (“vice chancellor for administration and chief financial officer”) and after the restructuring (“vice chancellor for finance and chief financial officer”):

	Decentralized Finance Model	Centralized Finance Model
Focus	Broader administrative role coupled with finance responsibilities	Narrower and deeper focus on finance and risk
Authority	Chancellor served as “effective CFO” on many finance and budgeting decisions	CFO has authority (and line of sight) to make finance and budgeting decisions on behalf of university in collaboration with academic provosts and hospital leadership
Collaboration with Other Academic Schools and Medical Center	Depended on quality of relationships	Authority conferred with new structure marks a starting point; relationships still matter
Visibility	Varied, depending on relationships	Much greater visibility into all finance matters throughout university

The vast majority of large U.S. universities rely on a traditionally decentralized finance function structure to manage the financial, and financial risk, implications of this complexity. Efforts to respond to and solve the financial challenges brought about by the economic conditions over the past year have been somewhat strained in the decentralized management structure.

“What keeps me up at night is figuring out how we are going to optimally allocate precious and scarce capital to support our mission,” says Sweet. “Having a coordinated finance team across the entire organization helps us see where to make the best investments.” Sweet, who previously worked in decentralized finance functions at other large universities, also credits the structure with delivering greater visibility into where the organization is currently spending money and where financial risks exist.

This explains why more academic institutions may soon take a page from the current Vanderbilt chancellor’s notebook. When they do, these universities will also need to address the implications of graduating to a new financial management structure (see “CFO of the Future” side bar).

Where the Traditional Finance Model Fails

Earlier in his career, Sweet left a CFO position with a medical school, in large part, because of a change in the school’s finance structure. The institution, which had decided to build its own hospital, hired a CEO who required the hospital to operate its own finance function independently of the college’s finance function. Sweet recalls that the proposed structural shift made him increasingly uncomfortable.

“Conflicts are built into the system when finance teams on a university’s medical and academic sides are separate,” he notes. These conflicts can influence collaboration, reporting lines, accountability, financial information transparency, financial management talent and, ultimately, the university chancellor’s role.

CFO of the Future

Earlier this year, Vanderbilt University hired Brett Sweet as CFO to lead the institution's newly centralized finance structure.

Sweet's background: Sweet previously served as dean for finance and administration of Harvard University's Faculty of Arts and Sciences. Before joining Harvard, he served as the executive vice president for finance and administration and CFO of Baylor College of Medicine (BCM); and, prior to BCM, as a principal with The Boston Consulting Group. A U.S. Naval Academy graduate, Sweet earned his MBA from Harvard and also served as an officer on a nuclear submarine.

Why he was hired: Besides Sweet's first-class professional experience, Vanderbilt University Chancellor Nicholas Zeppos points to Sweet's business experience, embrace of Vanderbilt's mission and service-oriented leadership style as prime factors in his selection. "The first thing Brett talked about was that he cared deeply about Vanderbilt's mission," Zeppos recalls. "And he brings a different perspective, from working in both the corporate world and in the Navy, to how we execute our mission...Bringing that focus and real-world experience is a very powerful combination."

How he operates: "One of the risks that finance organizations have in a corporate setting and, even more so, in a not-for-profit setting is 'the buck stops here' mentality," Sweet notes. "They sometimes think they actually decide where the money goes, and that can generate deep cynicism between finance and the people doing the mission work. Finance teams often head down a dangerous path when they believe they have to protect their organization by saying, 'No!' The only way to avoid that trap is by recognizing that the role of the finance team is to advise and serve the operating units. It's a matter of finance saying, 'Look, I'm here to advise you and tell you what I think. You can do A, B or C. If I were the dean, I would do B for the following reasons. Here are the risks and returns – both financial and return on mission.' But ultimately, it is their decision. you present it to them correctly, they will see that you are actually providing a service to them."

While finance teams from different parts of the university can still maintain good relationships with each other and the CFO's office on an informal basis in a decentralized structure, the informal nature of these alliances relies upon relationships with people rather than direct reporting lines, and therefore poses a certain level of inherent risk.

For example, if the provost, a vice-president or a dean prefers to operate independently, the CFO's office has no mandate to deter that inclination. This situation often places the financial manager who reports to that independent-minded provost, vice-president or dean in a difficult position; the financial manager may understand the university CFO's need for collaboration and information, but will understandably adhere to his or her direct reporting lines.

"Some people may say that an organizational chart does not ensure that collaboration occurs," Sweet acknowledges, "and they're correct. People still make these relationships work. However, the organizational structure serves as a valuable starting point and also something that everyone can point to when conflicts arise, as they inevitably do, and say, 'Wait a minute, this is the way we should do things.'"

Under a decentralized financial management model, the university's top CFO also confronts a fundamental conflict. "Many CFOs essentially have responsibility for oversight, management and leadership of the university's capital structure and debt markets while possessing virtually no direct oversight over how well the individual schools, or centers, within the university are performing from a cash, budgetary or working capital perspective," says Sweet. "How do you manage all of that when you don't have the direct oversight or even insight?"

This direct oversight conflict frequently is aggravated by the fact that financial talent is managed at the center or school level, which leads to a wider range of capabilities across the institution. While some deans or provosts rely on top-notch financial executives, others may inherit or opt to hire budget directors with limited cash management abilities. "This spectrum of capabilities puts the CFO at risk when the

board calls on the CFO to address, for example, whether capital is being put to good use,” Sweet adds.

A decentralized finance structure can also foist more financial decision-making responsibilities on the chancellor. During six years as provost at Vanderbilt University, before being appointed chancellor, Zeppos says he “was struck by how decentralized and almost un-strategic most large U.S. universities were in their financial strategy and financial analysis.” The prevailing “Vanderbilt responsibility center budget system” approach, Zeppos notes, did not generate sufficient discussion about the optimal use of university dollars.

“One of the faults of this model is that your chancellor is almost looked to as the CFO,” Zeppos continues. “If somebody comes to a provost with a request to build a building, the university needs a strong CFO to provide fact-based insight: ‘Here’s what I think and why I think it.’ A chancellor really needs a CFO who has earned the trust of the operating division officers and who sits at the table with you and provides valuable decision-making insights.”

Universal Drivers

Armed with misgivings about the decentralized finance structure, Zeppos reviewed the factors driving the need for an alternative approach once he became chancellor. He discovered the same drivers that pose challenges for every other large U.S. university:

1. **Growing Complexity:** The sheer range of activities, revenue streams and costs within American research universities has never been greater. Among other activities, for example, Vanderbilt educates 18-year-old future leaders; trains future doctors, ministers, lawyers and CEOs; and performs heart and liver transplants. This assortment results in a complex collection of capital investments, financial management methodologies and finance cultures. Traditional measures such as return on investment (ROI) don’t necessarily apply to academic investments where “return on mission” must be evaluated. “The complexity

involved in mixing the science of how we measure investments with the art of how we measure them is intense,” Sweet emphasizes. “Some of the investments we make may appear suboptimal financially, but we would say that they deliver a great return on mission.” This complexity creates an extremely diverse culture: compare the philosophy department to the surgery department in the medical school, for example. As a result, financial officers within different areas of the university speak different dialects of finance. “If you don’t understand these cultural differences as you try to bring financial discipline to bear,” Zeppos asserts, “you will not succeed.”

2. **Economic Volatility:** Prior to the onset of the recent recession, U.S. universities enjoyed a nearly 15-year period in which the economic environment remained relatively stable and predictable. Today, even the most extreme endowment-planning scenarios remain woefully inaccurate in the face of historic endowment drops. Capital markets essentially froze in 2008 and remain reluctant to thaw. The inflation/deflation picture remains disconcertingly muddled. And, as universities with medical centers are well aware, the federal government is contemplating the largest overhaul of the U.S. healthcare system in more than four decades. Additionally, universities could mortgage their way out of tight spots, if need be, during the past decade or so. Witness the explosion of five-star dormitory accommodations and new research buildings on campuses. Not that there were many tight spots prior to 2008: endowments, even in the wake of the dot-com crash, remained flush, and credit was easy to access. This is no longer the case; the access to, and impact of, each of those levers have been significantly reduced.

As Zeppos reviewed these factors as a chancellor he says “it became clear to me that I could not be both the chancellor and the CFO.”

A “One-University Strategy”

When Zeppos presented his case for a new, centralized finance structure to Vanderbilt’s trustees, the board responded eagerly.

“They were very supportive,” he recalls. “This is the model that prevails in the business world. I think some of the trustees were a little surprised at the degree of decentralization in our [previous] financial and budgeting structures.”

Despite the trustees’ receptivity, the new structure marked a significant departure, one that required a concerted change-management effort from Zeppos and the entire institution.

In business terms, Vanderbilt University is a \$3 billion-plus institution with a large medical center embedded in its operations. The medical center consists of an adult hospital, a children’s hospital, outpatient clinics and a medical school with undergraduate and graduate programs. The “school side” of the university consists of roughly 13,000 students, evenly split among traditional undergraduate and graduate students.

The medical center contributes about \$2 billion in annual revenue (with a roughly four percent net margin, as is typical among U.S. health systems) while the rest of the academic enterprise (which is essentially a break-even business) contributes the remainder, about \$1 billion. Historically, the “university side” and “the medical side” operated in relative isolation from each other.

Not anymore. Today, all of the finance teams throughout the entire enterprise report directly to the central finance office that Sweet leads. “From a practical and day-to-day perspective, the finance teams live in the schools and in the health system,” Sweet explains. “And they are truthfully working for the faculty and deans in their respective areas. But from a business perspective they are tied into the central finance office. Our belief here is that this will make a difference. Other institutions will say their finance teams are separate and that they make it work because of relationships. Our organizational structure in isolation doesn’t necessarily make it work – you still need to cultivate the relationships.”

Zeppos helped lay the groundwork for that sort of collaboration through a concerted effort to educate all of the university's constituents on the rationale behind the structural change. He says it was particularly important to explain his reasoning to the leaders on each side of the enterprise: the provost and the vice chancellor for health affairs.

"My point was that the new CFO would support our work as an objective advisor," Zeppos recalls. "I wanted them to understand that the new CFO would add tremendous value to our ability to execute on their strategic plans. This change, I emphasized, would support our 'one-university strategy' of teamwork at Vanderbilt."

Both executives bought into Zeppos' vision: the provost served on the CFO search committee, and the vice chancellor for health affairs chaired the committee. Trustees also played a key role in the search.

The new CFO, Sweet, describes the new finance structure's benefit in two words: more visibility.

"We have nearly \$2 billion of our \$3 billion of operations in the health center, which is where much of our risk exists," Sweet explains. "The need for visibility is great. With that visibility, we can see how much leverage in the balance sheet the medical center has created. In the past, that visibility did not always exist."

Visibility takes several forms, Sweet says. First, leadership can see more clearly where the university is spending money. Second, leadership can see where the university is making money. "We're not in the business of making money, but we do need to maintain a sustainable path," Sweet clarifies. And third, the university now can see exactly where it has invested funds. Together, these forms of transparency enable better decision-making at the leadership level.

In addition to greater visibility, Sweet says the centralized finance structure offers advantages related to risk management and to capital allocation decision-making.

“The risk management benefits are huge,” Sweet says. “At times in the past, the board could not have known the full extent to which risk – be it operational risk or financial risk – existed, or where it existed in the university.”

Capital allocation decisions loom as incredibly difficult exercises for U.S. universities during the next five years. Now that the academic arms race for biomedical professors, plush dorms and research buildings is waning, tough decisions await. For years, university leadership fielded capital allocation requests that totaled about two to three times available resources; in the next few years, these requests will likely amount to four to five times available resources.

“If you don’t have a coordinated finance team, you can’t really see where you need to make investments,” says Sweet. “When you have separate finance functions, I think the capital allocation decision-making process is disproportionately influenced by politics. There will always be some of that. However, if you coordinate the finances and the capital allocation – while aligning them with the goals and vision for the institution – you can dampen the politics that accompany the fights for precious capital dollars.”

Zeppos agrees. “I really believe,” he asserts, “that a centralized finance structure helps cultivate a more fact-based and forward-looking capital allocation decision-making process.”

Given the magnitude of challenges that have not confronted large U.S. universities since the Great Depression, it’s no surprise that Zeppos, as well as the leadership of other academic institutions, are eager for the opportunity to look ahead, rather than behind. And when they look ahead, it becomes clear that new relationships, if not a different financial management structure, anchored by a new way of thinking about the role of the CFO, and the individuals who fill this role, make sense.

About the Authors



Charles B. Eldridge is a Senior Client Partner in Korn/Ferry International's Financial Officers Center of Expertise, based in Atlanta.



Kenneth L. Kring is a Senior Client Partner in Korn/Ferry International's Philadelphia office and Managing Director of the North American Education Practice.



John A. Mattie is PricewaterhouseCoopers' National Education & Nonprofit Practice Leader, based in New York City.

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