 Managing in Turbulent Times

For several years, the Forum for the Future of Higher Education’s Annual Symposium has been preceded by a Master Class that examines current management and financial issues. Recent classes have addressed endowment spending policy, capital structure, and risk management. Given the fallout of the financial crisis, including widespread and dramatic declines in university endowments, increased demand for financial aid, and severe liquidity problems—as well as steadily rising operating costs—it was fitting that the Master Class focus on managing in turbulent times. The class began with a short case study, reproduced here, followed by a discussion that highlighted the need for executive vice presidents and chief financial officers to adopt a comprehensive view of the entire university—one that encompasses the academic as well as the business and finance side of their institution. This broadens the view typically taken by these officers; yet such a perspective is crucial to their fulfilling their roles as custodians of the overall university enterprise. Paul Marshall, MBA Class of 1960 Professor of Management Practice at the Harvard Business School, led the case discussion. He also described important characteristics of leaders in turbulent times and addressed the harsh realities of cost reduction—including making the difficult decisions that one must face when laying off employees. In the end, perhaps the most important leadership skills are the ability to engender trust and a sense of integrity and fairness throughout the difficult times and the changes they demand.

CASE STUDY: WINNINGTON UNIVERSITY

This case was written for the Master Class by William Massy, former chief financial officer and associate dean of the Stanford Graduate School of Business, and Professor Emeritus of Education and Business Administration at Stanford, with assistance from Paul Marshall, Dean Curry, vice president for business and finance at California Institute of Technology, and John Curry, former executive vice president at MIT.

Master Class participants were asked to consider three questions as they read the case:
• What are the major causes for the gap between costs and revenue at Winnington?
• What advice should Chuck Oversight give to the president of Winnington to improve the university’s position?
• What specific actions should the president take?

- It is appropriate that executive vice presidents and chief financial officers adopt a comprehensive view of the entire university—one that encompasses the academic as well as the business and finance side of their institution.
- The first step a president of a university facing the need for cost reduction should take is to create a sense of urgency about the crisis without instilling a feeling of hopelessness.
- There is a natural tendency for costs to grow in any organization, and for those costs to be defended and justified as necessary and prudent. Leaders of troubled organizations need to overcome this natural inertia to cost reduction.
- Labor costs should not be considered fixed over the long run. For example, finding more productive tasks for less active tenured faculty (so-called “fixed cost” employees) can enable reductions in other labor categories.
- In the end, most people can accept layoffs, even when they lose their jobs, if they trust the organization’s leadership and the layoffs are done according to a plan that is perceived as fair.
Chuck Oversight…decides to flag the president on the risks he sees in continuing to operate within the traditional model of higher education, which he believes is unsustainable in the long-run. He urges the president to increase productivity by adopting new ways of teaching and learning…

The case:

Charles F. (“Chuck”) Oversight, Executive Vice President at Winnington University, stared again at the latest admission and financial aid report.

At best the news was mixed. The applicant pool was almost steady but yield was down again, more sharply than in prior years, and the financial aid budget was under heavy pressure due to the economy’s effect on parental assets. Enrollment targets had been inched up in recent years and tuition boosted faster than the competition in order to make ends meet, but now that strategy appeared to be reaching its limits. There would be an immediate budget gap, which would only get worse as the smaller freshman cohort propagated to the upper-class years.

The endowment also was in trouble. Its market value was down 25% and allocations to private equities had produced major liquidity problems. And if that wasn’t enough, working capital was dangerously short because a substantial portion of the Expendable Funds Pool had been invested alongside the endowment. (See Table 1.)

Chuck believed, based on a recent Forum meeting at the Brookings Institution, that this would not be a V-shaped recession but rather a U-shaped one (with a broad bottom) or maybe even L-shaped (open-ended). Things seemed likely to bottom out by the end of the year, but instead of an endowment bounce-back he’d been told to expect “normal” 6-8 percent returns going forward. Although it would be many years before the losses from 2008-09 worked their way through the smoothing formula, the handwriting of a structural deficit was on the wall.

Chuck doubted that Winnington could increase revenue enough to “sell its way out” of the deficit. The University expected to achieve some success from the Obama economic stimulus package’s call for “beaker-ready” research projects, but to sustain the extra volume in the face of growing competition would require substantial cost sharing. And while any new sponsored research was welcome, there was no doubt that it would increase the risk profile of Winnington’s operating revenues—a point Chuck recalled vividly from the Forum Master Class of 2007. Finally, gift receipts were more likely to slow than to accelerate, and further enrollment hikes probably were not feasible.

Winnington had substantial borrowing capacity that could be used to weather its short-term problems and provide generous phase-in time for solutions to the structural deficit. However, because no one expected a sharp rise in revenue or asset values to cover balloon payments, borrowing now would impact the University’s budget for years to come.

So where might a long-term solution be found? Chuck was reminded of two operating trends that might offer clues. First, the ratio of administration and support cost to total operating expenditures had been growing steadily. No simple cause could be assigned to the increases, but they were troubling given the expectations for efficiencies following the implementation of new enterprise administrative systems. He worried further about the fact that lots of the administrative growth had taken place in schools and academic departments rather than in central offices. Could these costs be rolled back?

Second, teaching loads for research-inactive faculty were down significantly. Chuck harbored the uneasy feeling that, given the absence of demonstrable quality improvements, this represented a drain on productivity. Average class size was down too as more professors taught their specialties, even though some departments bucked the trend with ever-larger adjunct faculty. The use of adjunct faculty was up as well—especially the kind that could be hired cheaply for a course or two on the “spot market.” In other words, unexamined trends on the academic side of the enterprise seemed inconsistent with the University’s financial prospects and might even threaten its position in the marketplace.

Chuck knew his concerns were less about specific practices than about what appeared to be a myopic culture that accepted or even celebrated the traditional ways of doing things. Moreover, no one had a clear view of the University’s overall business model—how all the pieces fit together into an economically viable whole. He worried that the traditional model, which had served most universities well since World War II, might have become dangerously obsolete. He recalled from Forum meetings, for example, that information technology and cognitive science were transforming teaching and learning and that the U.S. was losing its monopoly over global top-quality higher education. Even without considering the recent financial problems, business as usual seemed to be fraught with danger.

Whose job is it to develop and advocate a strategic business model for the University, Chuck wondered? Should it be his? But if so, how could his views about the model’s academic elements gain traction? Recent conversations with the President and Provost suggested they were beginning to worry as well—but that, as former professors in the arts and sciences, how to conceive such a model lay outside their expertise. Just yesterday the President had asked him for advice. How should he respond?
CASE DISCUSSION

The major causes for the gap between costs and revenue at Winnington are clear. The endowment’s market value fell 25% and, likewise, projected payouts are declining; current year gifts are down, reflecting declines in household wealth and economic uncertainty; and financial aid is up, virtually erasing tuition increases. And, finally, expenses continue to increase.

In giving advice to the president, Chuck Oversight distinguishes between what the institution can control and the external causes of the problems they face. Broadly speaking, the financial crisis and the recession were beyond the control of the institution, and the pace of the endowment’s recovery largely will depend upon the pace of recovery in the wider economy and the financial markets. Declines in gifts are largely externally driven as well. (While one could argue that changes in endowment management practices and fund raising efforts could increase the endowment and level of giving, changes in these revenue sources were overwhelming externally driven and likely will continue to be so.)

It would, of course, be possible to increase the endowment spending rate in order to compensate for the losses. Many institutions had done exactly this, but Oversight was wary of this strategy and knew the trustees were too. Everyone acknowledged that one purpose of the endowment was to buffer the institution from the effects of rainy days—and it certainly was raining! However, raising the rate could not compensate for Winnington’s structural deficit. So doing would draw out more money than could be expected from investment return and thus, eventually, spend down the endowment. Oversight believed the trustees might authorize a higher rate for a limited time to aid in a transition to solvency, but only after a detailed plan for eliminating the structural deficit had been proposed and approved.

One possibility for eliminating the structural deficit was to make Winnington’s financial aid policies less generous. However, cutting need-based aid would conflict with the institution’s mission and efforts to recruit more students from lower-income families—and thus bring on even more outside pressure to serve a more representative student body. Cutting merit aid would affect the institution’s ability to recruit high-achieving students and raise fundamental concerns about quality. In the same vein, accepting more students to counter the previous year’s lower yield could negatively affect Winnington’s reputation.

Perhaps Winnington could delay capital projects to cut costs in the short-term, but Oversight is well aware that in project management, time is cost. Instead, Winnington could cancel capital projects but, again, concerns about quality and reputation would have to be taken into account.

Winnington could tweak its business model and generate new sources of revenue by charging students in higher cost or higher demand programs more. For example, engineering students would pay higher tuition than English majors. Winnington could also increase its offerings for nontraditional students, including retirees and alumni, both during the academic year and through summer programming. Not surprisingly, concerns about quality and reputation come into play in this realm as well, and complicate such efforts to increase revenue.

The reality, Oversight acknowledges, is that 60% of Winnington’s total expenses are labor costs. The ratio of administration and support staff to total operating expenditures has been steadily growing and, at the same time, teaching loads for research-inactive faculty have been declining significantly. Moreover, the use of adjunct faculty is up, undermining Winnington’s reputation at the least, and very likely affecting its quality too.

Oversight takes a comprehensive view of the entire university—including these issues on the academic side of the enterprise in addition to his usual focus on the business and finance side—and decides to flag the president on the risks he sees in continuing to operate within the traditional model of higher education, which he believes is unsustainable in the long-run. He urges the president to increase productivity by adopting new ways of teaching and learning, methods that use technology to customize learning, for example, have been shown to be more

Table 1. Winnington University Estimated Financial Results

For the years ended June 30, 2009 through 2011 (in thousands of dollars)

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010 (est)</th>
<th>2011 (proj)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Student Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tuition and fees</td>
<td>317,684</td>
<td>335,157</td>
<td>346,887</td>
</tr>
<tr>
<td>Less financial aid</td>
<td>(128,662)</td>
<td>(137,813)</td>
<td>(147,615)</td>
</tr>
<tr>
<td>Total Student Income</td>
<td>189,022</td>
<td>197,344</td>
<td>199,272</td>
</tr>
<tr>
<td>Sponsored Research Support</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct costs</td>
<td>133,734</td>
<td>138,414</td>
<td>148,719</td>
</tr>
<tr>
<td>Indirect costs</td>
<td>40,120</td>
<td>41,524</td>
<td>42,978</td>
</tr>
<tr>
<td>Total Sponsored Research</td>
<td>173,854</td>
<td>179,938</td>
<td>189,697</td>
</tr>
<tr>
<td>Current Year Gifts in Support of Operations</td>
<td>27,698</td>
<td>24,375</td>
<td>17,062</td>
</tr>
<tr>
<td>Investment Income Distributed for Operations</td>
<td>198,496</td>
<td>173,684</td>
<td>138,947</td>
</tr>
<tr>
<td>Special Program Fees and Other Income</td>
<td>106,617</td>
<td>110,349</td>
<td>114,211</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>695,687</td>
<td>685,689</td>
<td>659,189</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and benefits</td>
<td>415,407</td>
<td>429,946</td>
<td>444,994</td>
</tr>
<tr>
<td>Other operating expenditures</td>
<td>223,681</td>
<td>231,509</td>
<td>239,612</td>
</tr>
<tr>
<td>Depreciation</td>
<td>55,573</td>
<td>56,129</td>
<td>56,680</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>694,660</td>
<td>717,584</td>
<td>741,296</td>
</tr>
<tr>
<td><strong>Excess of Revenue Over Expenditures</strong></td>
<td><strong>1,027</strong></td>
<td><strong>(31,895)</strong></td>
<td><strong>(82,107)</strong></td>
</tr>
</tbody>
</table>
effective than traditional pedagogical approaches—both in the short-term and in long-term retention testing. And they are more cost effective, particularly for teaching students introductory-level material. Oversight points out that advances in the cognitive sciences have the potential to transform teaching and learning, making it more productive and effective. He urges the president to support and embrace new pedagogical methods informed by such discoveries, which will enable far more students to be educated with the same labor force that Winington currently employs. Greater efficiency, for example, could lead students to earn their undergraduate degrees in three years rather than the traditional four or more years.

Oversight’s key point is to insist that labor costs need not be considered fixed in the long run. Productivity increases from tenured faculty (“fixed cost” employees) can allow reduction in other labor categories. Meanwhile, though, Oversight knows that labor costs need to be reduced quickly. Hiring freezes can help prevent costs from rising and could slowly reduce tenured faculty positions (and others), but those savings are not enough to address the projected $82 million shortfall within the next couple years.

It is time for the president to take the lead, communicate a sense of urgency, and put forth a plan for layoffs.

LEADERSHIP STYLE AND SKILLS

The first step a president of any university facing the need for cost reduction should take is to create a sense of urgency about the crisis. While it’s easy to scare people, the aim is to at the same time present a plan about how, by doing things differently, the university can break the momentum taking it in the wrong direction and work its way out of the problem. The key is to create a sense of urgency without instilling a feeling of hopelessness.

There is a natural tendency for costs to grow in any organization, and for those costs to be defended and justified as necessary and prudent. Leaders of troubled organizations need to overcome this natural inertia to cost reduction. The best method is to convince employees—in this case, faculty, administration and staff—that the crisis is a threat to the institution’s future survival if some action is not taken. Crises are very useful as motivators for action, and leaders should view them as an opportunity to create a sense of urgency within their organization. With a sense of urgency and some fear of future survival it is possible to develop cost reductions plans that would, in more normal times, be difficult to envision. Further, the fact that the current crisis on campus is a result of external issues and threats presents the opportunity to implement changes while avoiding the complications of internal blaming and finger pointing.

The skill needed by leaders to create an environment conducive to change and cost reduction is the ability to articulate the problem being faced and to bring the organization to an understanding of the seriousness of the threat, while at the same time offering a plan or at least a short-term agenda that will guide the organization towards a solution to the problem.

Further, leaders must be both candid about the problem and optimistic about its resolution. They need to be energetic and willing to put in the long hours necessary to understand just what needs to be done, and in contact and communication with employees. Now is the time to dig down into the details that otherwise would be filtered up by deans, vice presidents, and the like.

Now is not the time for leaders to delegate. They need to be informed and decisive, and build trust in their leadership. Trust is built by increasing the perception of the leader’s ability, benevolence and integrity. Ability, of course, needs to be proven—and is best done at this point by achieving successful outcomes of decisions that are evident in the short-term. Perceptions of benevolence flow from displays of understanding employees’ concerns and by acting fairly. Integrity is evidenced by acting with openness, honesty, consistency and dependability, and by the willingness to admit mistakes. Trust in leadership makes the difficult task of cost reduction less painful for all.

COST REDUCTION

As previously mentioned, no cost is fixed in the long run: productivity increases from tenured faculty (“fixed cost” employees) can allow reductions in other labor categories. In any case, when labor cost reductions are necessary, first find out what matters most to employees. Often, they prefer that wages, benefits and hours be changed so as to avoid at least some layoffs. Turning to part-time or job sharing arrangements can be risky, though, and not as effective as one might think because benefit costs tend to remain high.

So now it’s time to face layoffs. Layoffs fall into three primary areas: voluntary, non-voluntary, but without a plan, and non-voluntary with a plan.

Voluntary layoffs are the least desirable route to take simply because most often the worst people who don’t have options stay, and the best people leave. Voluntary layoffs effectively lower the average skill level of the workforce. Moreover, it’s rare that voluntary layoffs achieve the end reduction goal and so involuntary layoffs need to follow. Further, a hiring freeze needs to be put in place so that those who left voluntarily aren’t simply replaced, negating cost reductions. And finally, it’s not uncommon that people who take voluntary layoffs get
hired back as consultants to do their old jobs—and you’ve just spent money getting them to leave. Voluntary layoffs are tempting because they’re not as hard to do, nor is the institution vulnerable to lawsuits claiming discrimination of many types. But to ensure the long-term viability of the institution, hard steps must be taken.

Non-voluntary layoffs without a plan are based on criteria such as seniority, across-the-board reductions, and personal relationships with the person making the decisions. These methods say to those in the organization that the leadership doesn’t know what to do. Across the board cuts, for example, mean that no assessment has been made regarding the relative value of each office, department or school to the institution and its mission. This approach also fosters deal-making that could well lead to lawsuits as people talk to each other throughout the ordeal. Worse, it conveys a lack of leadership precisely when it is most needed.

The best approach to reducing labor costs is to undertake non-voluntary layoffs with a plan. First, a reduction goal should be set for the entire institution based on financial exigencies. The goal should be significantly higher than one might think, because all the pressure will be to do less, not more, when it comes to cutting jobs. Each office, department, center, etc., should be reviewed and a reduction goal set for each. Goals will vary and, in fact, it may be that some units will not need to make any cuts. The sum of these cuts may exceed the total goal but, again, that is desirable given the considerable pressure to do less.

Once goals are decided upon, the managers of each unit should evaluate and rank their employees along two dimensions, value and commitment, as shown in Figure 1.

The set of people in the lower left quadrant, low value and low commitment, are the first to layoff. Any well-run organization won’t have many of these employees, and so will need to look further to meet reduction goals. At the other end of the spectrum, the set of people in the upper right quadrant, high value and high commitment, need immediate attention. They need to be reassured and even given incentives to stay. Yet it’s the group in the upper left quadrant, high value but low commitment, who often (in better times) are given the best deals to stay—which in the long run simply encourages lack of commitment. Further, the high value and high commitment people are those to whom across-the-board reductions and “sharing the pain” approaches seem most unfair.

Figure 2 shows the personnel actions associated with each quadrant.

The high value but low commitment group includes people who could leave anytime. They should be closely supervised so that someone else can replicate what they do, and backup plans should be developed in case they leave. The aim is to avoid losing a valuable person doing an important job that no one else knows how to do.

The most difficult set of people to handle is the low value and high commitment group. How they are treated is viewed by the rest of the employees as indicative of your humanity and fairness. It is very hard because some of these people are going to have be laid off, and you need to be as fair and consistent as possible with them.

Once each unit has produced a prioritized list for layoffs, the institution’s president and senior management conduct a comprehensive review of the lists, and make trade-offs between units as appropriate. The terms of severance should be developed based on laws, contracts and standards of fairness, and then the layoffs should be implemented quickly and simultaneously. The president should communicate with the
remaining employees to explain the process and clear up misunderstandings. Although tempting, the president should not make any promises that there will be no more layoffs.

In the end, most people can accept layoffs, even when they lose their jobs, if they trust the organization’s leadership and the layoffs are done according to a plan that is perceived as fair.

CONCLUSION
One of the benefits of a comprehensive and formal review of any organization’s labor force is that it reveals marginal activities. For decades, colleges and universities have engaged in mission creep, expanding their activities and efforts and spreading resources among them. Now, in a time of drastically reduced endowments, declining revenues and budget shortfalls, not only do labor costs need to be reviewed and reduced, but the viability of institutional programs needs to be carefully considered as well. Chief financial officers have an important part to play in these reviews given their role as custodians of the university-wide enterprise. In short, the fundamental question of mission must be dealt with, and in light of the current economic outlook, the reality is that only those institutions that become mission-centered will survive.

PAUL MARSHALL is the MBA Class of 1960 Professor of Management Practice at Harvard Business School, and is affiliated with the Entrepreneurial Management Unit there. He teaches a course, The Entrepreneurial Manager in the Turnaround Environment, on the role of managers trying to execute an operational turnaround in a company in distress. Marshall is also faculty chairman of the Global Colloquium on Participant Centered Learning, a program that teaches professors from around the world how to teach using the case method. He can be reached at pmarshall@hbs.edu.

WILLIAM MASSY is Professor Emeritus of Higher Education and former vice president for business and finance at Stanford University, where he also served as vice provost for research, acting provost, professor and associate dean at the Graduate School of Business, and Director of the Stanford Institute for Higher Education Research. His most recent books include Academic Quality Work: A Handbook for Improvement (2007) with Stephen Graham and Paula Short, and Remaking the American University: Market-Smart and Mission-Centered (2005) with Robert Zemsky and Gregory Wegner. Massy is currently an independent consultant to universities worldwide, focusing on quality and productivity issues in higher education. He can be reached at wmassy1@comcast.net.