



## Examination of the Council on Postsecondary Education's Implementation of the *Bucks for Brains* Endowment Programs

We applaud Governor Patton for the priority his administration has attached to improving the quality of higher education, and the General Assembly for appropriating money for the innovative *Bucks for Brains* program. With additional funding, however, comes a greater responsibility to ensure that taxpayer dollars are marshaled and leveraged effectively. Unfortunately, accountability has not developed at a pace equal to the funding.

### Summary

Although Kentucky is now in the second biennium of postsecondary education reform, the Council on Postsecondary Education (CPE) has not achieved optimal supervision and administration of the two endowments comprising the *Bucks for Brains* program.

The Legislature's investment of \$120 million in the two endowment programs for this biennium deserves more focused supervision by CPE than that given the initial \$110 million appropriation during the last biennium. CPE has clarified the 2000-2002 guidelines for distribution, but there remain gaps in its policies that threaten to reduce the impact of the significant taxpayer investment in improving postsecondary education.

Only 33% of the \$110 million appropriated by the 1998-2000 Executive Branch Budget and the General Fund Surplus Expenditure Plan (House Bill 321) was used to endow chairs. Line-item budget restrictions and other evidence document that the General Assembly's appropriation had targeted endowing chairs as the most effective strategy to propel Kentucky's public universities into national prominence.

CPE's distribution guidelines have allowed *Bucks for Brains* funds to be used by universities outside mission-related areas of concentration. Furthermore, CPE has not set minimum endowments for endowed chairs, and has allowed universities to use questionable matches to receive *Bucks for Brains* funds. Practices we find troubling include matching endowment dollars with state-generated dollars and university-affiliated dollars. Although current distribution guidelines have been clarified, they still do not explicitly prohibit certain questionable matches. As a

result, newly appropriated dollars may also not be leveraged effectively.

Finally, CPE has been slow in implementing reporting requirements on the use of the original \$110 million. Although CPE has recently received the second round of required reports, it still has not fully implemented a reporting mechanism that allows for monitoring how the universities are spending the *Bucks for Brains* funds or whether the money is being used in the manner stated by universities.

House Bill 1 granted CPE authority to implement a system of accountability that measures the use of resources, as well as the authority to devise policies that provide for allocation of funds among universities. Despite these provisions, CPE has not been proactive in providing the necessary supervision to ensure appropriate distribution and use of *Bucks for Brains* funds.

This report is not suggesting that any public university has acted improperly. Rather, the report highlights areas of concern in CPE's supervision of the *Bucks for Brains* program.

### Background

*The Kentucky Postsecondary Education Improvement Act of 1997 (House Bill 1)*

House Bill 1 created CPE to provide accountability of public universities and related appropriations. The duties of CPE are set out in KRS 164 as follows:

- KRS 164.095(3)(d) states that CPE "shall develop and implement a system of accountability for the postsecondary education institutions that measures the use of resources."
- KRS 164.020(9) states that CPE shall "devise, establish, and periodically review and revise policies to be used in making recommendations to the Governor for consideration in developing recommendations to the General Assembly for appropriations to the universities...." It goes on to state that CPE "has sole discretion, with advice of the Strategic Committee on Postsecondary Education and the executive officers of the postsecondary education

system, to devise policies that provide for allocation of funds among the universities....”

With the passage of House Bill 1, the General Assembly set forth goals to be achieved on behalf of the people of the Commonwealth by the year 2020. These goals are codified in KRS 164.003. They include (1) a major comprehensive research institution ranked nationally in the top twenty public universities at the University of Kentucky (UK); (2) a premier, nationally recognized metropolitan research university at the University of Louisville (UofL); and (3) at least one nationally recognized program of distinction or one nationally recognized applied research program at each of the six regional universities.

*\$126.9 Million 1998-2000 Biennial Budget Line Items Appropriated for Multiple Purposes*

Section 7 of House Bill 1 (1997) created a Strategic Investment and Incentive Funding Program consisting of six incentive trust funds which would foster research, technology, workforce development, and other quality programs. Money was appropriated to these trust funds which could be used for endowed professorships, endowed chairs, external research grant matches, graduate assistantships, junior faculty research, or other programs and related accounts as determined through CPE’s biennial budget request.

To demonstrate their commitment to the goals of House Bill 1, the General Assembly appropriated \$15 million to three of the trust funds for fiscal year 1998. In House Bill 321, the 1998 General Assembly appropriated an additional \$126.9 million to the six trust funds for the 1998-2000 biennium.

*Additional \$110 Million 1998-2000 Biennial Budget Line Items Restricted to “Endowed Chairs”*

During the 1998 legislative session, the Kentucky General Assembly enacted House Bill 321, which provided incentives for Kentucky’s public universities to enhance their research capabilities. It also established a plan for the expenditure of General Fund surplus money, which included an appropriation of \$110 million for two endowment programs overseen by CPE during the 1998-2000 biennium. The General Assembly stipulated that this appropriation of state funds should be matched on a dollar for dollar basis by university fundraising, and should be used for endowed chairs.

Two of the trust funds established in House Bill 1 received an appropriation of \$110 million for endowments. The Research Challenge Trust Fund received a transfer of \$100 million from the General Fund for an endowment program and the Regional University Excellence Trust Fund

received \$10 million from the General Fund for a similar endowment program. The exclusive purpose specified in House Bill 321 for this appropriation was “endowed chairs.”

We reviewed Legislative Research Commission (LRC) minutes of the January 1998 meeting of the House Committee on Appropriations and Revenue’s Subcommittee on Education where the proposed *Bucks for Brains* program was being discussed as a way to increase the number of endowed chairs in Kentucky’s universities. At this meeting, the State Budget Director stated that “the number of endowed chairs and professorships on a college campus is one measure of academic excellence.” He went on to explain to the subcommittee that “by comparison in top 20 research institutions throughout the country, we find these institutions have many more than we have....”

CPE allocated two-thirds of the Research Challenge Trust Fund Endowment to UK and one-third to UofL. The Regional University Excellence Trust Fund Endowment was allocated to each regional university in proportion to its respective share of total general fund appropriations in each fiscal year.

The following table summarizes the current status of the initial endowment dollars allocated to UK, UofL, Eastern Kentucky University (EKU), Kentucky State University (KSU), Morehead State University (MoSU), Murray State University (MuSU), Northern Kentucky University (NKU), and Western Kentucky University (WKU). CPE did not establish a deadline by which universities had to match the endowment dollars that House Bill 321 allocated to them. In effect, the unmatched money is available indefinitely, according to CPE.

**Table I. Distribution Status of Endowment Dollars as of June 30, 2000**

| <i>University</i>  | <i>Amount Allocated</i> | <i>Amount Matched</i> | <i>Amount Remaining to be Matched</i> |
|--|-------------------------|-----------------------|---------------------------------------|
| <b>Research Challenge Trust Fund Endowment Program</b>             |                         |                       |                                       |
| UK   | \$66,667,000            | \$66,667,000          | \$0                                   |
| UofL   | 33,333,000              | 33,333,000            | 0                                     |
| <i>Total</i>   | <b>\$100,000,000</b>    | <b>\$100,000,000</b>  | <b>\$0</b>                            |
| <b>Regional University Excellence Trust Fund Endowment Program</b> |                         |                       |                                       |
| EKU  | \$2,498,000             | \$2,463,000           | \$35,000                              |
| KSU  | 774,000                 | 100,000               | 674,000                               |
| MoSU   | 1,475,000               | 1,267,115             | 207,885                               |
| MuSU   | 1,710,000               | 774,250               | 935,750                               |
| NKU  | 1,232,000               | 1,232,000             | 0                                     |
| WKU  | 2,311,000               | 2,311,000             | 0                                     |
| <i>Total</i>   | <b>\$10,000,000</b>     | <b>\$8,147,365</b>    | <b>\$1,852,635</b>                    |

Source: Auditor of Public Accounts, from information provided by the Council on Postsecondary Education.

*\$120 Million 2000-2002 Biennial Budget Line Items Allocated to "Endowment Programs"*

During the 2000 legislative session, the Kentucky General Assembly enacted House Bill 502, which provided an additional \$120 million to public universities for "endowment programs." Of the total appropriation, \$100 million was appropriated to the Research Challenge Trust Fund Endowment Program and \$20 million was appropriated to the Regional Universities Excellence Trust Fund Endowment Program.

Submissions by universities requesting matching 2000-2002 funds are currently being approved. Already, WKU has matched its total allocation of \$4.5 million, while UK has matched \$25.7 million of its \$66.7 million allocation, according to CPE.

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### Definitions used in this Report

A **Foundation** is a nonprofit organization that supports charitable activities in order to serve the common good. Foundations are often created with endowments and generally make grants or operate programs with the interest earned from investing the endowments.

An **Endowment** is a permanent funding source for fellowships, professorships, or other programs that benefit the universities. Endowment funds cannot be spent; they may be invested. The investment earnings are either made available to the university or reinvested for future use.

An **Endowed Chair** is a permanent funding source for a faculty position. Endowment investment earnings are made available to provide salary or salary supplements and to pay associated expenses of the occupant of the chair.

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### Briefing Report Objectives, Scope, and Methodology

The Auditor of Public Accounts (APA) examined the Research Challenge Trust Fund Endowment and Regional University Excellence Trust Fund Endowment to determine whether they were carried out in an appropriate manner and as intended by the General Assembly. Unless otherwise noted, all statistics mentioned in this examination include data available through June 30, 2000. In conducting this examination, we performed the following procedures:

- Interviewed staff of CPE
- Interviewed the State Controller
- Interviewed staff of the Finance and Administration Cabinet
- Interviewed staff of the Governor's Office of Policy Management

- Reviewed the distribution and reporting guidelines established by CPE
- Reviewed individual pledge sheets submitted by each university for consideration by CPE for matching eligibility through June 30, 2000
- Reviewed House Bills 1, 321, and 502 as well as KRS Chapters 164 and 211, and KRS 42.540
- Reviewed minutes from a legislative committee meeting
- Reviewed minutes of CPE meetings and CPE committee meetings
- Reviewed the Final Budget Memorandum for 2000-2002

This briefing report, its findings, recommendations, and conclusions do not constitute a full performance audit. However, applicable government auditing standards were followed.

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### Findings

#### **CPE did not require universities to use matching funds to endow chairs as was mandated by the 1998-2000 budget of the Commonwealth.**

The budget language of House Bill 321 specifically states that its appropriation should be used for "endowed chairs." House Bill 1, on the other hand, merely sets forth the broad goals of the Commonwealth for postsecondary education. CPE chose to base its guidelines on the general language of House Bill 1 rather than the specific mandates of House Bill 321. As a result of this permissive interpretation, most of the money intended for endowed chairs in the first biennium was used for other purposes.

House Bill 1 is not the legislation that established or appropriated money to the two endowment programs comprising the Research Challenge Trust Fund and the Regional University Excellence Trust Fund. A stricter interpretation should have been embraced. Interpretation of the appropriation's purpose should rely primarily on budget testimony before the House Committee on Appropriations and Revenue's Subcommittee on Education during consideration of House Bill 321.

That testimony invoked an increase in the number of endowed chairs as the focus of increasing the level of academic excellence in the Commonwealth. In light of this testimony and the explicit language of House Bill 321, we believe that the *Bucks for Brains* funds should have been used to endow chairs.

However, through June 30, 2000, approximately 67% (\$72,991,015) of all funds matched by CPE (\$108,147,365) was for purposes other than endowed

chairs. Table II exhibits the breakdown of dollars matched by endowment purpose at all eight universities.

**Table II: Purpose of Endowment Dollars as Expressed by each University in its Request for State Matches through June 30, 2000\***

|              | <i>Chairs</i>       | <i>Professorships</i> | <i>Fellowships</i> | <i>Research Support</i> |
|--------------|---------------------|-----------------------|--------------------|-------------------------|
| UK           | \$16,487,100        | \$7,567,800           | \$4,844,050        | \$37,768,050            |
| UofL         | 16,055,000          | 1,000,000             | 675,000            | 15,603,000              |
| EKU          | 2,125,000           | 113,000               | 0                  | 225,000                 |
| KSU          | 0                   | 100,000               | 0                  | 0                       |
| MoSU         | 0                   | 892,115               | 200,000            | 175,000                 |
| MuSU         | 489,250             | 285,000               | 0                  | 0                       |
| NKU          | 0                   | 750,000               | 375,000            | 107,000                 |
| WKU          | 0                   | 2,311,000             | 0                  | 0                       |
| <b>Total</b> | <b>\$35,156,350</b> | <b>\$13,018,915</b>   | <b>\$6,094,050</b> | <b>\$53,878,050</b>     |

Source: Auditor of Public Accounts, from information provided by the Council on Postsecondary Education.

\*Amounts represent only the state-matched portion of each endowment. If no particular purpose was denoted in the pledge, this amount was credited to research support.

**CPE's 2000-2002 distribution guidelines continue the authority to use matching funds for purposes other than endowed chairs.**

CPE, in its recently approved distribution guidelines for the 2000-2002 appropriation, has reiterated its permissive interpretation. For example, CPE again promulgated broad distribution guidelines to accommodate the following areas:

- Endowed chairs, which provide salary or salary supplements and associated expenses for additional positions.
- Endowed professorships, which provide funding for salary supplements and expenditures associated with the enhancement of existing positions.
- Endowed graduate fellowships at research universities, which provide funding for fellowship stipends that recognize outstanding graduate students.
- Endowed scholarships and fellowships at regional universities, which provide funding for scholarship and fellowship stipends that recognize outstanding students.
- Endowed research and graduate mission support for research universities, which provide support for the improvement of priority programs of national distinction.
- Comprehensive mission support for regional universities, which provide funding for the improvement of priority programs of national distinction.

As a result, a large percentage of the \$120 million biennial appropriation may be too broadly diffused to help universities achieve intended levels of excellence.

CPE stated that since the endowment programs are programs contained within the original trust funds, the broader intent of House Bill 1 should be observed. They also stated that in order to attract occupants for endowed chairs, they felt compelled to allow the universities to use *Bucks for Brains* funds for research, laboratories, and other support.

**CPE has allowed universities to create endowments outside university-selected areas of concentration.**

Not only have the majority of funds been used for purposes other than endowed chairs, money was also used outside of university-defined areas of concentration. This may result in *Bucks for Brains* funds not being used for mission-related areas of concentration.

Universities have outlined missions that include areas of concentration within which the endowment and matching funds are to be used. Examples of such initiatives include advanced medical research, justice and safety, early childhood issues, logistics and distribution, and entrepreneurship. However, donations to various universities have been approved by CPE for state matches in the following areas:

- Horticulture (\$110,400)
- Arts administration (\$500,000)
- Tax law (\$100,000)
- Music (\$550,000)
- Real estate (\$166,300)
- Library communications (\$30,750)
- An honors program (\$113,000)

As a result, endowment dollars have not been focused in the areas of concentration specified by the universities and may have been spread too thinly to have the desired impact in these concentrated areas.

**CPE has failed to set appropriate minimum matching amounts for endowed chairs.**

Initially, a CPE workgroup suggested that chairs should be endowed at \$2 million each, professorships at \$250,000 to \$1 million, and everything else should be endowed in increments of \$50,000. However, CPE chose not to incorporate this suggestion into the distribution guidelines for either biennium.

The importance of setting appropriate minimum matching amounts becomes more clear in light of university spending rules. For example, strict spending rules are customarily applied to determine the amount of money available to fund endowed chairs. They permit an evaluation of how much money must be provided from the endowment in order to produce adequate salaries.

For example, if a university which has adopted a 5% spending rule receives a donation of \$1 million and a match from CPE of \$1 million to endow a chair, then the endowment will provide \$100,000, or 5% of \$2 million, annually. However, lesser endowments would not provide adequate salaries to attract qualified professionals. A 1999 National Association of College and University Business Officers' study reports that UK and NKU have established 5% spending rules, while UL uses a 5.5% spending rule.

If the proposed minimum matching amounts discussed by the workgroup had been imposed on the universities, then 30 of the 48 endowed chairs (63%) created by the 1998-2000 appropriation would have been disallowed because, despite the dollar for dollar match by CPE, they would have fallen below the \$2 million minimum.

CPE takes the position that decisions related to minimum matching amounts should be left to the individual universities. Still, to avoid wasting administrative resources, CPE set a \$50,000 minimum eligible matching amount for UK and UL. To attract national scholars, CPE staff stated that \$50,000 endowments would more than likely be combined for each position rather than stand alone. When asked, CPE stated that a minimum match was not set for regional universities, since those universities were considered less likely to have alumni positioned to make large gifts.

CPE should impose minimum endowments for chairs at all universities. As mentioned previously, provisions within House Bill 1 grant CPE the authority to proactively develop policies related to the allocation of funds. Although CPE oversees autonomous universities under various governing boards, we believe it can still be proactive in requiring minimum matching amounts. This would ensure system-wide consistency, optimized state investment, and more effective recruitment of national scholars.

**CPE has not resolved the use of Bucks for Brains interest income.**

As of June 30, 2000, approximately \$4,228,840 in interest income from the original appropriation contained in House Bill 321 has not been distributed to the universities. CPE is discussing this issue with the Finance and Administration Cabinet and State Budget Director.

House Bill 321 authorizes the investment of the endowment appropriation by CPE until such time as one of the eight public universities states that formal commitments have been secured to provide the matching requirements as determined by CPE. Currently, the Finance and Administration Cabinet invests this money for CPE and maintains each university's money in a separate account. According to the State Controller and the CPE

Budget Analyst from the Governor's Office of Policy Management, the interest could be matched by universities.

During the CPE Finance Committee meeting on July 17, 2000, staff was directed to correspond with the State Budget Director and the Secretary of the Finance and Administration Cabinet seeking clarification on the use of the interest income. CPE staff sent a letter requesting clarification of the issue.

The Secretary of the Finance and Administration Cabinet responded by sending a letter stating that no specific authorization is required prior to expending trust fund investment earnings, but that expending such earnings should be consistent with the language and intent of House Bill 1 and distributed to the institutions. According to CPE, a final decision has not been made on the use of interest income.

**CPE has sanctioned practices that do not optimize private donations.**

We identified two practices that weakened the leveraging of private donations by state matching during the 1998-2000 biennium. First, CPE matched state generated dollars. Second, CPE matched university-affiliated dollars.

The public policy embodied in House Bill 321 contemplates a university fundraising focus on new donations from individuals, corporations, and non-profit foundations. By including state-generated and university-affiliated dollars, CPE diluted the Commonwealth's \$110 million investment in postsecondary education and reduced the incentive for private fundraising by universities. As depicted in Table III, the impact of questionable matches for the initial appropriation is \$8,987,400.

**Table III: Questionable Donations Approved by CPE through June 30, 2000**

| <i>University</i> | <i>State-generated dollars approved as matching funds</i> | <i>University-affiliated dollars approved as matching funds</i> |
|-------------------|---|---|
| UK                | \$2,500,000   | \$3,882,400   |
| UofL              | 1,480,000   | 0   |
| EKU               | 0   | 1,125,000   |
| <i>Total</i>      | <b>\$3,980,000</b>  | <b>\$5,007,400</b>  |

Source: Auditor of Public Accounts, from information provided by the Council on Postsecondary Education.

Fund types approved for matching by CPE for the 1998-2000 biennium included business or corporate gifts, gifts from alumni or other private individuals, agency funds contributed by affiliated corporations, auxiliary enterprises and other entities (such as hospitals), federal government

funds that can be used for permanent institutional endowments, and other funds specifically approved by the CPE.

CPE's distribution guidelines for 2000-2002 funds have removed the wording related to funds received from the federal government and affiliated entities. Even so, the guidelines are still too permissive and do not state which sources are prohibited from being matched.

#### *Matching State Dollars with State-Generated Dollars*

Matching state dollars with state-generated dollars neutralizes part of the intent of House Bill 321, yet CPE has matched almost \$4 million in state funds by deeming donations made by the Kentucky Spinal Cord and Head Injury Research Board eligible for state matching. Established in 1994 by the General Assembly, the Kentucky Spinal Cord and Head Injury Research Trust Fund supports spinal cord and head injury research through a \$12.50 surcharge on speeding tickets. According to KRS 211.504, all the money generated by the Trust Fund goes toward research projects at UK and UofL.

We are not suggesting that the Kentucky Spinal Cord and Head Injury Research Board acted improperly. Rather, we believe that dollars generated as a result of existing state programs should not be eligible for matching by *Bucks for Brains* funds. In the future, CPE should disallow matches for funds received from the Kentucky Spinal Cord and Head Injury Research Board or other funds resulting from state programs.

#### *Matching State Dollars with University-Affiliated Dollars*

In its 1998-2000 distribution guidelines, CPE provided matching funds for donations made by foundations affiliated with the universities. UK alone has received matching funds for approximately \$791,300 in donations by university affiliated entities that are included in the university's financial statements. These entities include the following:

- UK Athletics Association
- UK Research Foundation
- UK Business Partnership Foundation

We identified an additional \$4,216,100 in matching funds pledged by three entities that are listed in KRS 42.540, which states that all nonprofit fiduciaries holding funds for the benefit of any form of state organization must report all money received and disbursed during each fiscal year to the Office of the Controller. The following is a list of these entities:

- Kentucky Medical Services Foundation
- ECU Foundation
- The McDowell Cancer Network, Inc.

Although the 1998-2000 distribution guidelines allow donations from university-affiliated entities to be matched, we view this practice as an overly permissive interpretation of the legislative intent of House Bill 321. CPE should work to ensure that university-affiliated matches are not used to circumvent the intent of this bill.

As previously stated, House Bill 321 structured a process that encouraged new donations from individuals, corporations, and nonprofit entities. CPE must ensure that preexisting donation streams are not used to circumvent the intent of this legislation.

#### **CPE has not developed a detailed reporting mechanism on the use of *Bucks for Brains* funds.**

Although CPE asserts that it requires detailed reporting of how endowment and matching dollars are used, it was late in meeting its self-imposed reporting deadline of July 1, 1999. As a result, CPE has delayed the implementation of a detailed reporting mechanism to assure greater accountability among the universities for their use of *Bucks for Brains* funds.

In the spring of 2000, CPE formalized the reporting standards with feedback from the universities. The reporting guidelines state that universities should submit both a narrative and financial summary for each endowment item on an annual basis. A new deadline of July 1, 2000, was established by CPE for reports concerning the activities of each university's endowment program through FYE June 30, 1999. It also established October 15, 2000, as the deadline for reports through FYE June 30, 2000. All universities except KSU have submitted their reports for FYE June 30, 1999 and FYE June 30, 2000.

Although the submission of reports is a step in the right direction, CPE should require additional documentation to show that universities are actually using the *Bucks for Brains* funds as indicated in their requests. In addition, the universities should be reporting annually their success at meeting the goals and objectives tied to matched funds. CPE should conduct site visits to make these determinations.

A reporting mechanism would also help ensure better accountability over matches of pledges. Over \$57 million of the more than \$108 million matched by CPE through FYE June 30, 2000, were pledges to be fulfilled within five years. CPE stated they are in the process of developing a "tickler file" to track whether universities

actually receive their pledges. Although this is a step in the right direction, such a process should be in place and should be reflected in CPE's policies before additional money is matched. It should be noted that CPE has recently developed a policy to address pledges that do not materialize.

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### **Recommendations**

CPE should:

- Establish procedures that reflect legislative intent to define how future appropriations to the endowment programs may be used and determine whether current and future guidelines should be modified.
- Establish procedures that limit the eligibility or use of matching dollars for non-mission-related areas of concentration.
- Establish minimum funding levels for each type of endowment. This would ensure that endowments generate the annual revenue necessary to attract or retain scholars of national distinction.
- Develop a plan in consultation with the Finance and Administration Cabinet and the State Budget Director to ensure maximization of endowment program interest income.
- Establish stricter guidelines for the eligibility and source of donations. Specify that state-generated and university-affiliated dollars should not be used to match the state-appropriated endowment dollars.
- Implement a reporting system to enable it to evaluate the use and effectiveness of endowment dollars and present its findings annually to the General Assembly.