

Audits, Financial Standards, Limitations, & Cohort Rates

Schools that participate in the FSA programs are generally required to have annual compliance and financial statement audits. This chapter will discuss the audit requirement and the financial standards and limitations that apply to a school's FSA eligibility. In addition, we will discuss the annual calculation of a school's cohort default rate.

FSA AUDIT REQUIREMENTS FOR SCHOOLS

A school that participates in any FSA program, including a participating foreign school, generally must have an independent auditor conduct an annual audit of the school's compliance with the laws and regulations that are applicable to the FSA programs in which the school participates (a compliance audit), and an audit of the school's financial statements (a financial statement audit).

While a compliance audit covers the school's administration of the FSA programs, a financial statement audit provides the Department with information necessary to evaluate a school's status *vis-a-vis* the financial standards that are discussed later in this chapter.

The type of compliance audit a school or servicer must undergo depends on its type of control: public, for-profit, or nonprofit.

- All for-profit schools must have an FSA compliance audit conducted under the Inspector General's *Audit Guide* (for FSA school audits), which is available on the IFAP website.
- Public and nonprofit schools must comply with the Single Audit Act. The Single Audit Act requires these schools to have an audit conducted in accordance with the Office of Management and Budget's (OMB) Circular A-133, Audits of States, Local Governments, and Nonprofit Organizations. (Circular A-133 allows an FSA compliance audit under the criteria of the *Audit Guide* under limited circumstances.)

The Office of Inspector General (OIG) also conducts audits, usually in cases where there is concern over a school's administration of the FSA programs. An OIG or other federal audit does not satisfy the requirement that a school have annual compliance and financial statement audits performed by an independent public accountant.

Note that audit requirements also apply to third-party servicers. However, a school may never use a third-party servicer's audit in place of its own required audit because the school is ultimately liable for its own violations as well as those incurred by its third-party servicers.

CHAPTER 4 HIGHLIGHTS

- FSA audit requirements for schools
- Timing of audit submissions
- Standards & guidelines for FSA audits
- 90/10 revenue test
- Audits and the audit review process
- Audits for 3rd-party servicers
- Demonstrating financial responsibility
- Standards for financial responsibility
- Alternatives to the general financial standards
- Past performance & affiliation standards
- Limitations
- Cohort default rate

Related information

- Administrative requirements, *Chapter 3*
- Program reviews, *Chapter 9*

School participation teams

For information regarding accounting and compliance issues, a school should contact the School Participation Team for its region. See the contact information on the IFAP website (ifap.ed.gov).

Audit requirements & waiver

HEA: Sec. 487(c)
20 USC 1094
34 CFR 668.23(a)(1) to (5)
Waiver: 34 CFR 668.27

Independent CPA/auditor

An independent certified public accountant or government auditor, except that a government auditor must meet the Government Auditing Standards qualification and independence standard, including standards related to organizational independence.

Opportunity to send comments to Small Business Ombudsman

The Small Business and Agriculture Regulatory Enforcement Ombudsman and 10 Regional Fairness Boards were established to receive comments from small businesses about federal agency enforcement actions. The Ombudsman annually will evaluate the enforcement activities and rate each agency's responsiveness to small business. If you wish to comment on the enforcement actions of the Department of Education, call 1-888-REG-Fair (1-888-734-3247).

Fiscal year for 2012–2013

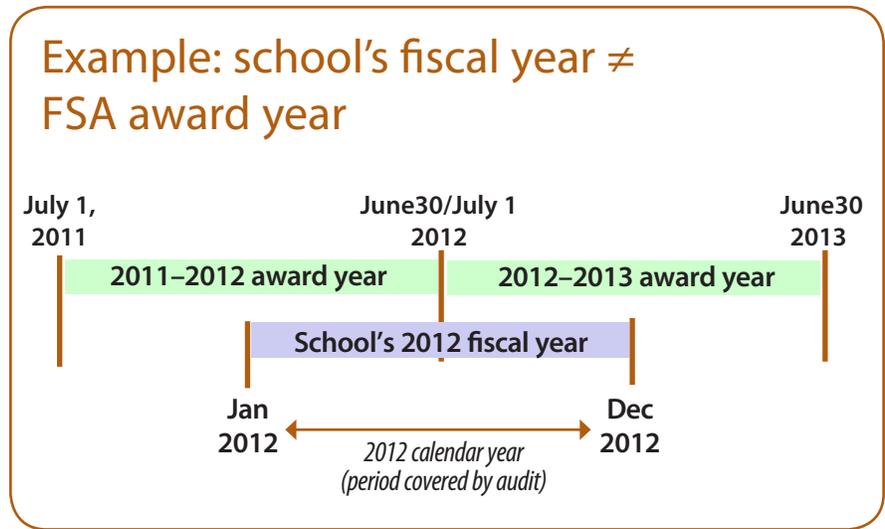
For schools using a calendar year as their fiscal year, their most recently completed fiscal year is the one that ends on December 31, 2012. For those schools using the award year as their fiscal year, their most recently completed fiscal year will be the one that ends on June 30, 2013.

TIMING OF AUDIT SUBMISSIONS

Simultaneous FSA audit submissions

A school that has an audit performed under the *Audit Guide* for FSA schools must submit both the compliance audit and the audited financial statements within six months of the end of the school's fiscal year. Both audits must be prepared by an independent public accountant in accordance with the Generally Accepted Accounting Principles (GAAP) and audited in accordance with the Generally Accepted Government Auditing Standards (GAGAS). The compliance audit and financial statement audit may be performed by different auditors. However, the audits must be submitted as one package.

Both the compliance audit and the financial statement audit must be performed on a fiscal-year basis. In cases where the school's fiscal year does not coincide with an award year, the school's compliance audit will cover parts of two award years (see example).

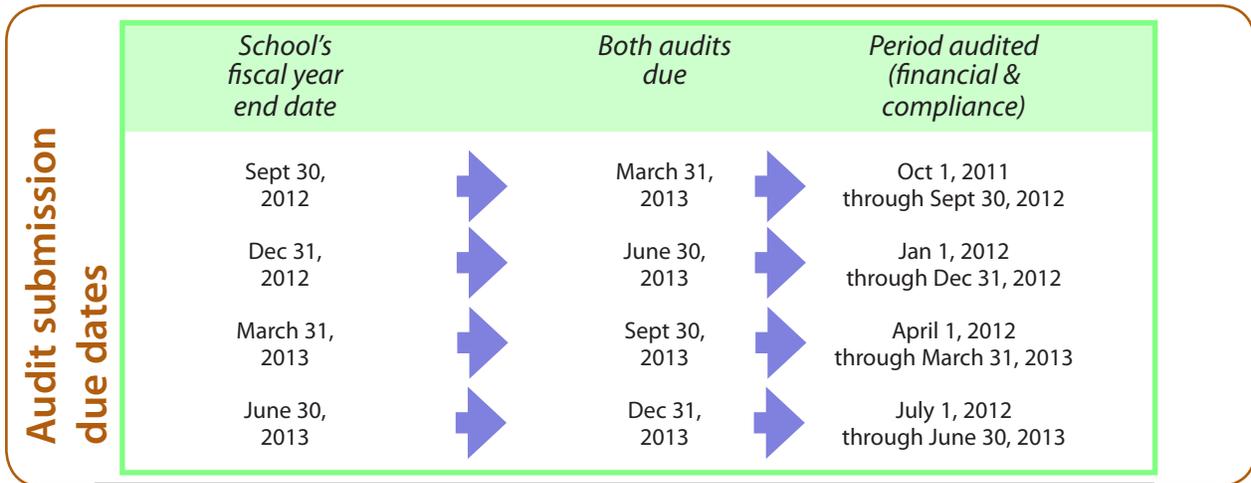


Submission dates for FSA audits

A school's or servicer's annual compliance and financial statements audits performed under the *Audit Guide* must be based upon the fiscal year and submitted to the Department within six months after the end of the school's or servicer's fiscal year. (These requirements do not apply to audits performed under the Single Audit Act that are due as specified in OMB Circular A-133.)

The chart on the next page lists audit due dates and the period the audit must cover. (The chart provides information for the most common institutional fiscal-year-end dates.)

Generally, a school's first audit performed under these requirements must cover the entire period of time since the school began to participate in the FSA programs. Each subsequent audit must cover the period since the end of the period covered by the preceding audit that is accepted by the Department.



Waivers of requirement for an annual FSA audit

A school may request a waiver of the requirement for an annual audit for up to three years.

- A proprietary school must have disbursed less than \$200,000 dollars in each of the two most recently completed award years to be eligible for the waiver. (The school must also meet the other regulatory conditions in 34 CFR 668.27.)
- A public or private nonprofit institution that expends less than \$500,000 in federal funds in a fiscal year is exempt from filing compliance audits after the school gains initial eligibility.

If the waiver is approved, at the end of the waiver period the school must submit a compliance audit covering each individual fiscal year in the waiver period and a financial statement audit for the last year of the waiver period.

This exception to the annual audit requirement may not be granted for the award year preceding a school's required recertification.

If the Department grants the waiver, the school does not have to submit its compliance or audited financial statement until six months after—

- the end of the third fiscal year following the fiscal year for which the school last submitted a compliance audit and audited financial statement; or
- the end of the second fiscal year following the fiscal year for which the school last submitted compliance and financial statement audits if the award year in which the school will apply for recertification is part of the third fiscal year.

A school's waiver request may include the fiscal year in which that request is made, plus the next two fiscal years.

A school remains liable for repaying any FSA funds it improperly expends during the waiver period. A compliance audit is the vehicle for discovering improper expenditures. Therefore, a school will be required to pay any liabilities when the school eventually submits a compliance audit for the fiscal years in which it made improper expenditures.

Audits required at end of waiver period

The regulations do not waive the requirement that a school audit its administration of the FSA programs; they waive the requirement that these audits be submitted on an annual basis. Therefore, if a school is granted a waiver for three years, when the waiver period expires and the school must submit its next compliance audit, that audit must cover the school's administration of the FSA programs since the end of the period covered by its last submitted compliance audit.

The auditor for a proprietary school must attest to, the school's annual 90/10 determination for each individual year in the waiver period (in accordance with 34 CFR 668.23(d)(4)).

Rescinding the waiver

The Department rescinds a waiver if the school:

- disburses \$200,000 or more of FSA program funds for an award year;
- undergoes a change in ownership that results in a change of control; or
- becomes the subject of an emergency action or a limitation suspension, fine, or termination action initiated by the Department or a guaranty agency.

Qualifying for waiver

To qualify for a waiver, a school must demonstrate that it:

- is not a foreign school;
- disbursed less than \$200,000 in FSA program funds during each of the two completed award years prior to the audit period;
- agrees to keep records relating to each award year in the unaudited period for two years after the end of the regular record retention period for the award year;
- has participated in the FSA programs under the same ownership for at least three award years preceding the school's waiver request;
- is financially responsible under the general requirements of financial responsibility and does not rely on the alternative standards and requirements of exceptions to participate in the FSA programs;
- is not receiving funds under the reimbursement or cash monitoring system of payment;
- has not been the subject of a limitation, suspension, fine, or termination proceeding, or emergency action initiated by the Department or a guaranty agency in the three years preceding the school's waiver request;
- has submitted its compliance audits and audited financial statements for the previous two fiscal years, and no individual audit disclosed liabilities in excess of \$10,000; and
- submits a letter of credit in the amount as determined below, which must remain in effect until the Department has resolved the audit covering the award years subject to the waiver. For purposes of this section, the letter of credit amount is 10% of the total FSA program funds the school disbursed to or on behalf of its students during the award year preceding the school's waiver request.

Examples of effects of waivers

Example 1: The school is still required to have its administration of the FSA programs audited for the waiver period. If a school is granted a waiver for three years, when the waiver period expires, the next audit must cover the school's administration of the FSA programs since the end of the period covered by its last submitted compliance audit. For example, if a school's fiscal year coincides with an award year (July 1–June 30), it submits a compliance audit for its fiscal year that ends on June 30, 2012, and then receives a waiver so that its next compliance audit is due six months after the end of its 2014–2015 fiscal year. When it submits that audit, it must cover the 2012–2013, 2013–2014, and 2014–2015 fiscal years.

Example 2: If a school's fiscal year ends June 30, 2012, and the school receives a waiver on May 1, 2012, the next compliance audit is due six months after the end of the school's 2014–2015 fiscal year.

STANDARDS & GUIDELINES FOR FSA AUDITS

Audited financial statement requirement

A school's audited financial statement must cover the school's most recently completed fiscal year. The Department uses the information in a school's audited financial statement to evaluate the school's status *vis-a-vis* the financial standards discussed in this chapter. In addition to a school's audited financial statement, the Department may require that the school submit additional information. For example, the Department may require a school to submit or provide access to the auditor's work papers. Also, if the Department finds it necessary to evaluate a particular school's financial condition, the Department can require a school to submit audited financial statements more frequently than once a year.

FSA compliance audits

Compliance audits must be conducted in accordance with the general standards and the standards for compliance audits contained in the U.S. General Accountability Office's (GAO's) Government Auditing Standards. In addition, the auditor should use the following guidance, based on school type:

- Public and private nonprofit schools audited under Single Audit Act: OMB Circular A-133.
- For-profit schools, foreign schools, and third-party servicers: the latest *Audit Guide* for the FSA programs (see sidebar).

In conducting an audit, the auditor may also find it useful to consult the accounting and recordkeeping manual for the FSA programs (known as *The Blue Book*) and the *G5 Users Guide*, as applicable.

A school (or third-party servicer) may use the same independent auditor or auditing firm for its required nonfederal audit as the one that usually audits its fiscal transactions. To produce unbiased conclusions, the auditor must be independent of those authorizing the expenditure of FSA funds.

The Department may require a school to provide a copy of its compliance audit report to guaranty agencies, lenders, state agencies, other federal agencies, or accrediting agencies.

Single Audit Act (A-133 audit) guidelines

Nonprofit and public schools are required to have audits performed under the guidelines of the Single Audit Act. (These audits are also known as "A-133 audits" because the audit guidelines are established in OMB Circular A-133). A-133 audits satisfy the Department's audit requirements.

A-133 audits have distinct auditing and submission requirements and must be submitted to the Federal Audit Clearinghouse. (A copy of the audit must also be submitted to the Department through the eZ-Audit website.) A school submitting an audit under the guidelines of the Single Audit Act must use the submission deadlines established by the Single Audit Act.

Audit guide (for FSA programs)

The official title of the Inspector General's audit guide for the FSA programs is *Audits of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers*.

The audit guide and the "Blue Book" are available on the IFAP website (ifap.ed.gov) under "Publications."

The G5 Users Guide is available at <https://www.g5.gov/>

Financial statements must use accrual basis & GAAP standards

Financial statements must be prepared on an accrual basis in accordance with generally accepted accounting principles (GAAP) and audited by an independent auditor in accordance with GAGAS and other guidance contained in OMB Circular A-133, or in the Department's *Audit Guide* (for FSA school audits).

Circular A-133 & the Single Audit Act

Office of Management and Budget (OMB) Circular A-133 was issued pursuant to the Single Audit Act of 1984. The Single Audit Act was amended in 1996—the current requirements are found in Chapter 75 of title 31, U.S. Code.

Circular A-133 is titled "Audits of States, Local Governments, and Nonprofit Organizations" and is applicable to nonprofit postsecondary schools, states, local governments, and Indian tribal governments. For many schools, this is a combined audit of all the federal programs at that school. OMB circular A-133 is available through the OMB Home Page at

www.whitehouse.gov/omb/circulars/index.html

Submitting A-133 audits

The Form SF-SAC and the Single Audit Reporting packages for fiscal periods ending on or after January 1, 2008, must be submitted online to the Federal Audit Clearinghouse. <http://harvester.census.gov/sac/>

Annual financial statement

Section 487(c) of the HEA provides that all schools participating in the Federal Student Aid programs must submit *annual financial statements* to the Department. This applies to all schools, including non-profit schools that are otherwise exempt from submitting annual audited financial statements under the A-133 standards.

Exemptions

A school that expends less than \$500,000 of federal funds during a fiscal year is exempt from submitting an annual A-133 audit. However, a school that spends less than \$500,000 in all federal funds is still required to submit a financial statement to the Department within 6 months after the close of its fiscal year. The financial statement does not have to be audited by a CPA and may be created as compiled or reviewed statements. If the school has prepared a set of audited financial statements for its own use or for another entity, the school must submit those audited financial statements to the Department no later than six months after the end of the institution's fiscal year.

Circular A-133 permits the submission of program-specific audits if an entity expends funds in only one federal program *and* the program's regulations do not require a financial statement audit. The FSA program regulations require a financial statement audit. Therefore, a school may not submit a program-specific audit to satisfy the Department's audit submission requirements.

Circular A-133 also now allows an independent auditor to use professional judgment to determine whether certain federal programs must be included in the scope of an audit. An independent auditor can exclude certain program components, such as FSA program funds, if they fall below a predetermined dollar and risk threshold.

The independent auditor must make an annual assessment of the dollar and risk conditions and determine whether such exclusions are appropriate and whether any FSA programs must be included within the scope of the audit. You can find additional information on this topic in the latest Compliance Supplement to Circular A-133.

FSA consolidated statements

In some cases, a school's relationship with another entity may cause the Department to require a school to submit additional financial statements both of the school and the entity, such as audited consolidated financial statements; audited full consolidated financial statements; audited combined financial statements; or, under certain circumstances, audited financial statements of one or more related parties. This occurs when the Department determines that the activities or financial health of another entity may impact upon the school's total financial health. So that the Department can make this determination, a school must include in its audited financial statements a detailed description of related entities based on the definition of a related entity in the *Statement of Financial Accounting Standards* (SFAS) 57. In addition, the description must include all related parties and a level of detail that would enable the Department to readily identify the related party. This information may include but is not limited to the name, location, and description of the related entity, including the nature and amount of any transaction between the related party and the school, financial or otherwise, regardless of when it occurred.

90/10 REVENUE TEST

A proprietary school must disclose the percentage of its revenues derived from the FSA programs that the school received during the fiscal year covered by the audit as a footnote to its audited financial statements. The school must also report in the footnote the dollar amount of the numerator and denominator of its 90/10 ratio as well as the individual revenue amounts identified in section 2 of appendix C to subpart B of part 668 (see sidebar).

A school that converts from a for-profit to a nonprofit status must report its compliance with the 90/10 revenue test for the first year after its conversion. A school changing from for-profit to nonprofit must continue to file this report for the first year of its nonprofit status.

To be eligible for FSA participation, a proprietary school must derive at least 10% of its revenues for each fiscal year from sources other than the FSA programs, or be subject to sanctions. The calculation of this percentage and the funds included must be arrived at using the cash basis of accounting. A school must determine its revenue percentages using the formula described in the chart on the following pages each fiscal year.

Proprietary schools have 45 days after their most recent fiscal year has ended to report to the Department if they did not satisfy the 90/10 Rule for that period.

- If a school fails to satisfy the 90/10 rule for any fiscal year, it becomes provisionally certified for up to two fiscal years after the fiscal year it failed to satisfy the revenue requirement. (Among other factors, the provisional certification is limited by the expiration date of the school's program participation agreement.)
- If a school fails to satisfy the 90/10 rule for two consecutive fiscal years, it loses its eligibility to participate in the FSA programs for at least two fiscal years.

If the school loses eligibility, it must immediately stop awarding FSA funds and follow the closeout procedures described in *Chapter 9*.

90/10 Rule

Guidance on footnote disclosures can be found in the *FSA Audit Guide*, in 34 CFR 668.23(d)(4), and in appropriate accounting references.

See DCL GEN-08-12 for changes made by the *Higher Education Opportunity Act of 2008* (section 493), moving 90/10 rule to the Program Participation Agreement (from the definition of a proprietary institution of higher education).

Earlier guidance on 90/10 and institutional loans and scholarships can be found in Dear Partner Letter GEN-99-33 and Dear CPA Letters CPA-99-01 and CPA-99-02.

HEA section 487

34 CFR 668.14(b)(16)

34 CFR 668.28

Notifying ED—90/10

A school must send notice of its failure to satisfy the 90/10 Rule to the Department by U.S. mail or commercial overnight to the following address:

U.S. Department of Education,
Federal Student Aid
School Eligibility Service Group
830 First Street, NE
Washington, DC 20202-5403

General e-mail: Caseteams@ed.gov

Contact phone numbers for the teams are provided at: <http://eligcert.ed.gov/>

Counting revenues for the 90/10 rule

Section 668.28(a) of the Student Assistance General Provisions provides the following explanation of how to count revenue from FSA vs. non-FSA sources: See Appendix C of Subpart B of the Student Assistance General Provisions for calculation procedures.

(3) Revenue generated from programs and activities.

The institution must consider as revenue only those funds it generates from—

- (i) Tuition, fees, and other institutional charges for students enrolled in eligible programs as defined in §668.8;
- (ii) Activities conducted by the institution that are necessary for the education and training of its students provided those activities are—
 - (A) Conducted on campus or at a facility under the institution's control;
 - (B) Performed under the supervision of a member of the institution's faculty; and
 - (C) Required to be performed by all students in a specific educational program at the institution; and
- (iii) Funds paid by a student, or on behalf of a student by a party other than the institution, for an education or training program that is not eligible under §668.8 if the program—
 - (A) Is approved or licensed by the appropriate state agency;
 - (B) Is accredited by an accrediting agency recognized by the Secretary under 34 CFR part 602;
 - (C) Provides an industry-recognized credential or certification, or prepares students to take an examination for an industry-recognized credential or certification issued by an independent third party;
 - (D) Provides training needed for students to maintain state licensing requirements; or
 - (E) Provides training needed for students to meet additional licensing requirements for specialized training for practitioners that already meet the general licensing requirements in that field.

(4) Application of funds.

The institution must presume that any Title IV, HEA program funds it disburses, or delivers, to or on behalf of a student will be used to pay the student's tuition, fees, or institutional charges, regardless of whether the institution credits the funds to the student's account or pays the funds directly to the student, except to the extent that the student's tuition, fees, or other charges are satisfied by—

- (i) Grant funds provided by non-federal public agencies or private sources independent of the institution;
- (ii) Funds provided under a contractual arrangement with a federal, state, or local government agency for the purpose of providing job training to low-income individuals who need that training;
- (iii) Funds used by a student from a savings plan for educational expenses established by or on behalf of the student if the saving plan qualifies for special tax treatment under the Internal Revenue Code of 1986; or
- (iv) Institutional scholarships that meet the requirements in paragraph (a)(5)(iv) of this section.

(5) Revenue generated from institutional aid.

The institution must include the following institutional aid as revenue:

- (i) For loans made to students and credited in full to the students' accounts at the institution on or after July 1, 2008, and prior to July 1, 2012, include as revenue the net present value of the loans made to students during the fiscal year, as calculated under paragraph (b) of this section, if the loans—
 - (A) Are bona fide as evidenced by standalone repayment agreements between the students and the institution that are enforceable promissory notes;
 - (B) Are issued at intervals related to the institution's enrollment periods;
 - (C) Are subject to regular loan repayments and collections by the institution; and
 - (D) Are separate from the enrollment contracts signed by the students.

[For rules on calculating the Net Present Value of the these loans, see 34 CFR 668.28(b) and the Appendix C to Subpart B]
- (ii) For loans made to students before July 1, 2008, include as revenue only the amount of payments made on those loans that the institution received during the fiscal year.
- (iii) For loans made to students on or after July 1, 2012, include as revenue only the amount of payments made on those loans that the institution received during the fiscal year.
- (iv) For scholarships provided by the institution in the form of monetary aid or tuition discount and based on the academic achievement or financial need of its students, include as revenue the amount disbursed to students during the fiscal year. The scholarships must be disbursed from an established restricted account and only to the extent that the funds in that account represent designated funds from an outside source or income earned on those funds.

(6) Revenue generated from loan funds in excess of loan limits prior to the Ensuring Continued Access to Student Loans Act of 2008 (ECASLA).

For each student who receives an unsubsidized loan under the FFEL or Direct Loan programs on or after July 1, 2008 and prior to July 1, 2011, the amount of the loan disbursement for a payment period that exceeds the disbursement for which the student would have been eligible for that payment period under the loan limit in effect on the day prior to enactment of the ECASLA is included and deemed to be revenue from a source other than Title IV, HEA program funds but only to the extent that the excess amount pays for tuition, fees, or institutional charges remaining on the student's account after other Title IV, HEA program funds are applied.

(7) Funds excluded from revenues.

For the fiscal year, the institution does not include—

- (i) The amount of Federal Work Study (FWS) wages paid directly to the student. However, if the institution credits the student's account with FWS funds, those funds are included as revenue;
- (ii) The amount of funds received by the institution from a state under the LEAP, SLEAP, or GAP programs;
- (iii) The amount of institutional funds used to match Title IV, HEA program funds;
- (iv) The amount of Title IV, HEA program funds refunded or returned under §668.22. If any funds from the loan disbursement used in the return calculation under §668.22 were counted as non-title IV revenue under paragraph (a)(6) of this section, the amount of Title IV, HEA program funds refunded or returned under §668.22 is considered to consist of pre-ECASLA loan amounts and loan amounts in excess of the loan limits prior to ECASLA in the same proportion to the loan disbursement; or
- (v) The amount the student is charged for books, supplies, and equipment unless the institution includes that amount as tuition, fees, or other institutional charges.

Other 90/10 guidance**Cash basis of accounting**

Except for institutional loans made to students under 34 CFR 668.28(a)(5)(i), a proprietary school must use the cash basis of accounting in calculating its revenue percentage under the 90/10 Rule. Under the cash basis of accounting, revenue is recognized when received rather than when it is earned.

Revenue

For the purpose of calculating the qualifying percentages under the 90/10 Rule, revenue is an inflow or other enhancement of assets to an entity, or a reduction of its liabilities resulting from the delivery or production of goods or services. A school may recognize revenue only when the school receives cash, i.e., when there is an inflow of cash. As a result, in order for a school to recognize revenue under the cash basis of accounting, that revenue must represent cash received from a source outside the institution.

Tuition waivers

Institutional grants in the form of tuition waivers do not count as revenue because no new revenue is generated. Similarly, internal transfers of cash among accounts are not considered revenue because they do not represent an inflow of cash to the institution. Institutional scholarships are not revenues generated by the school (unless they are donated by an unrelated or outside third party). An exception is permitted for schools to use donations from a related party to create restricted accounts for institutional scholarships, but only the amount earned on the restricted account and used for scholarships would count as revenue in the denominator of the calculation.

Funds held as credit balances in institutional accounts cannot be counted in the 90/10 formula. However, once funds held as credit balances are used to satisfy institutional charges, they would be counted in both the numerator and the denominator of the formula.

Revenues from loans

When a school makes a loan to a student, it does not receive cash from an outside source. Accordingly, cash revenue from institutional loans is recognized only when those loans are repaid, because that is when there is an inflow of cash from an outside source. Loan proceeds from institutional loans that were disbursed to students may not be counted in the denominator of the fraction, because these proceeds neither generate nor represent actual inflows of cash. The school may include only loan repayments it received during the appropriate fiscal year for previously disbursed institutional loans.

Loans made by a private lender that are in any manner guaranteed by the school are known as recourse loans. The proceeds from recourse loans may be included in the denominator of an institution's 90/10 calculation for the fiscal year in which the revenues were received, provided that the institution's reported revenues are also reduced by the amount of recourse loan payments made to recourse loan holders during that fiscal year. Note that recourse loan payments may be for recourse loans that were made in a prior fiscal year. Under the cash basis of accounting the reductions to total revenues in the denominator of the 90/10 calculation are reported in the fiscal year when the payments are made.

The nonrecourse portion of a partial recourse loan may be included in a 90/10 calculation. In order to include a partial recourse loan in a 90/10 calculation, the contract must identify the percentage of the sale that is nonrecourse; only that percentage may be included. Furthermore, no after-the-fact adjustments may be provided for. Revenue generated from the sale of nonrecourse institutional loans to an unrelated third party may be counted as revenue in the denominator of the 90/10 calculation to the extent that the revenues represent actual proceeds from the sale.

The sale of institutional loan receivables is distinguishable from the sale of a school's other assets because receivables from institutional loans are produced by transactions that generate tuition revenue. Tuition revenue represents income from the major service provided by a school. That would not be true in the case of the sale of other school assets.

Counting LEAP funds

Note that the LEAP Program is not funded beyond July 1, 2011, so the following guidance applies to LEAP grants funded before that date.

If a state agency specifies the exact amount or percentage of LEAP funds included in an individual student's state grant, only the specified amount or percentage of the student's state grant up to \$5,000 (the statutory maximum LEAP award) is considered LEAP funds.

If the state agency identifies a specific student's state grant as containing LEAP funds but does not provide an exact amount or percentage, the entire amount of the grant up to \$5,000 is considered LEAP funds. State grant funds that are not LEAP/SLEAP are included in the denominator.

If the state agency does not specify the amount of LEAP funds included in a student's individual grant but does specify the percentage of LEAP funds in the entire amount of state grant funds provided to the school and the student meets the FSA student eligibility requirements, the school must apply this percentage to the individual student's total state grant to determine the amount of the grant up to \$5,000 to be considered LEAP funds.

Use of eZ-Audit required

Schools are required to submit their compliance audits, audited financial statements, and letters confirming their status as public schools through the Department's eZ-Audit Electronic Financial Reporting System.

This requirement applies to any compliance audits or financial statements required under 34 CFR 600.20(a) or (b) to begin or continue participating in the FSA programs, any financial statements required due to a change in ownership resulting in a change in control as provided under 34 CFR 600.20(g), any compliance audits and financial statements required annually under 34 CFR 668.23, and any compliance audits and financial statements required when a school ceases to participate in the FSA programs as provided under 34 CFR 668.26(b).

Information about eZ-audit

Website: <http://ezaudit.ed.gov>
E-mail contact: fsaezaudit@ed.gov
eZ-Audit Help Desk: 877-263-0780.

Cooperation with audit & review process

Throughout the audit process, and for other examinations such as program reviews and state reviews, the school or servicer is required to cooperate fully with its independent auditor, the Department and its Inspector General, the Comptroller General of the United States, its accrediting agency, and the appropriate guaranty agency.

AUDIT & AUDIT REVIEW PROCESS

Having the audit performed

The school or servicer must make its program and fiscal records, as well as individual student records, available to the auditor. (Required recordkeeping is discussed in *Chapter 7*.) Both the financial aid and business offices should be aware of the dates the auditors will be at the school, and make sure that someone is on hand to provide requested documents and answer questions during that period.

At the end of the on-site review, the auditor conducts an exit interview. At a school, this exit interview is usually conducted with the personnel from the school's financial aid and other relevant offices. The exit interview is not only an opportunity for the auditor to suggest improvements in procedures, but it also gives the school or servicer a chance to discuss the draft report and review any discrepancies cited in the report. The exit interview is a good time to resolve any disagreements before the final report is prepared.

The final report is prepared by the auditor and submitted to the school or servicer.

Review of FSA audit submissions

The Department reviews the audit report for format and completeness and to ensure that it complies with the government's auditing standards.

We will use the general information to make an initial determination of whether the audits are materially complete and conducted in accordance with applicable accounting standards. Based on the financial data, we will also make a preliminary determination as to whether your school is financially responsible with respect to the financial responsibility ratios, or in the case of a change in ownership resulting in a change in control, whether the school satisfies the financial ratio requirements (discussed later in this chapter). Later, the Department will review submissions to determine whether the school must provide additional information or ED should take further action.

Based on the audit findings and the school's or servicer's written explanation, the Department will determine if any funds were spent improperly. Unless the school or servicer has properly appealed the decision, the school or servicer must repay any improperly spent funds within 45 days.

Access to records

Once the audit is complete, the school or servicer must give the Department and the OIG access to all records and documents needed to review the audit. A school that uses a third-party servicer must give the Department and the OIG access to all records and documents needed to review a third-party servicer's compliance or financial statement audit. In addition, the school's or servicer's contract with the auditor must specify that the auditor will give the Department and the OIG access to the records and documents related to the audit, including work papers. Cooperation includes providing timely and reasonable access to records (including computer records) for examination and copying, and to personnel for the purpose of obtaining relevant information.

eZ-Audit

The eZ-Audit website provides a paperless single point of submission for financial statements and audits (i.e., compliance reports). eZ-Audit provides automatic error checking as you enter the data and before submission. In addition, it gives you instant acknowledgment of receipt.

All schools that participate in the FSA programs must use eZ-Audit to submit financial statements and compliance audits (including copies of the A-133 reports that nonprofit and public institutions file with the Federal Audit Clearinghouse).

Nonprofit and public institutions are still required to submit their A-133 audits in writing to the federal clearinghouse.

The eZ-Audit process

To access the eZ-Audit website you must be a registered user. Each school must select an eZ-Audit institution administrator who will be responsible for managing your school's access to the eZ-Audit website. This institution administrator will receive the user name and password necessary for your school's access and will be responsible for granting access to others you name as additional users.

Each registered user must sign and retain the eZ-Audit rules of behavior. (For registration instructions and to download the rules of behavior, please visit ezaudit.ed.gov).

Once you have obtained your school ID, you will access the appropriate page on the audit website, and—

1. enter general information about your school's compliance audit and financial statement;
2. enter specific financial data directly from its audited financial statement; and
3. attach authentic electronic copies of the audit originals.

After you have entered the required information, you must attach a copy of the audit prepared and signed by the independent auditor. The copy must be in a non-editable, portable document format (PDF) created using Adobe Acrobat version 5.0 or higher.

Third-party servicers

Guidance for audits of third-party servicers is found in the January 2000 Department of Education's "Audit Guide, Audits of Federal Student Aid Programs at Participating Institutions and Institution Servicers."
34 CFR 668.23(a)(3) and (c)
34 CFR 668.23(d)(5)

AUDITS FOR THIRD-PARTY SERVICERS

Audit requirements also apply to third-party servicers. If a servicer contracts with several FSA schools, a single compliance audit can be performed that covers its administrative services for all schools. If a servicer contracts with only one FSA school and that school's own audit sufficiently covers the functions performed by the servicer, the servicer does not have to submit a compliance audit. A servicer must submit its compliance audit within six months after the last day of the servicer's fiscal year. The Department may require a servicer to provide a copy of its compliance audit report to guaranty agencies, lenders, state agencies, the Department of Veterans Affairs, or accrediting agencies.

In addition to submitting a compliance audit, a servicer that enters into a contract with a lender or guaranty agency to administer any aspect of the lender's or guaranty agency's programs must submit annually audited financial statements. The financial statements must be prepared on an accrual basis in accordance with GAAP and audited by an independent auditor in accordance with GAGAS and any other guidance contained in audit guides issued by the Department's Office of the Inspector General.

If the Department determines that, based on audit findings and responses, a third-party servicer owes a liability for its administration of the FSA programs, the servicer must notify each school with which it has a contract of the liability. Generally, unless they submit an appeal, schools and servicers owing liabilities must repay those liabilities within 45 days of being notified by the Department.

As noted earlier, a school may never use a third-party servicer's audit in place of its own required audit because the school is ultimately liable for its own violations as well as those incurred by its third-party servicers. (See *Chapter 3* for more information on third-party servicers.)

DEMONSTRATING FINANCIAL RESPONSIBILITY

To participate in the FSA programs, a school must demonstrate that it is financially responsible. To provide the Department with the information necessary to evaluate a school's financial responsibility, schools are required to submit financial information to the Department every year. A school must provide this financial information in the form of an audited financial statement as part of a combined submission that also includes the school's compliance audit. For-profit schools have six months from the end of the schools' fiscal year to provide the combined submission; other schools have nine months.

What follows is an overview of the financial responsibility standards. Schools should refer to Subpart L of the Student Assistance General Provisions for complete information.

The Department determines whether a school is financially responsible based on the school's ability to:

- provide the services described in its official publications and statements;
- properly administer the FSA programs in which the school participates; and
- meet all of its financial obligations.

The financial responsibility standards can be divided into two categories: (1) general standards, which are the basic standards used to evaluate a school's financial health, and (2) performance and affiliation standards, which are standards used to evaluate a school's past performance and to evaluate individuals affiliated with the school.

Financial responsibility for public schools

A public school is financially responsible if its debts and liabilities are backed by the full faith and credit of the state or another government entity. The Department considers a public school to have that backing if the school notifies the Department that it is designated as a public school by the state, local, or municipal government entity, tribal authority, or other government entity that has the legal authority to make that designation. The school must also provide the Department with a letter from an official of the appropriate government entity confirming the school's status as a public school. A letter from a government entity may include a confirmation of public school status for more than one school under that government's purview. The letter is a onetime submission and should be submitted as a separate document.

Public schools also must meet the past performance and affiliation standards discussed later and must submit financial statements prepared in accordance with generally accepted accounting principles (GAAP) and prepared on the accrual basis.

Financial responsibility for proprietary or private nonprofit schools

A proprietary or private nonprofit school is financially responsible if the Department determines that—

Financial responsibility

Sec. 498(c) of the Higher Education Act
34 CFR 668 Subpart L

Change in ownership

When a change in ownership occurs, the Department applies the standards in 34 CFR 668.15.

Financial responsibility

Treatment of long-term debt

DCL GEN 03-08, July 2003

34 CFR 668, Subpart L, Appendices A & B

Ratios

34 CFR 668.171(b)(3)

Refund reserve standard

34 CFR 668.173

Returning funds

34 CFR 668.172(c)

For withdrawn students, returns funds in a timely manner

34 CFR 668.22

- the school has a composite score of at least 1.5;
- the school has sufficient cash reserves to make the required refunds, including the return of Title IV funds (these requirements are known as the refund reserve standards);
- the school is meeting all of its financial obligations, including making required refunds, including the return of Title IV funds and making repayments to cover FSA program debts and liabilities; and
- the school is current in its debt payments.

These requirements are discussed in more detail in the next section.

Even if a school meets all of the general requirements, the Department does not consider the school to be financially responsible if—

- in the school’s audited financial statement the opinion expressed by the auditor was adverse, qualified, or disclaimed, or the auditor expressed doubt about the continued existence of the school as a going concern (unless the Department determines that a qualified or disclaimed opinion does not have a significant bearing on the school’s financial condition), or
- the school violated one of the past performance requirements discussed later in this chapter.

Additional information on composite scores

For complete information on the calculation of the composite score, schools should refer to Appendices A and B of Subpart L in the General Provisions regulations.

The Department issued guidance on the treatment of long-term and other debt in calculating these ratios in DCL GEN-01-02, which was subsequently replaced by DCL GEN-03-08.

STANDARDS FOR FINANCIAL RESPONSIBILITY

Composite score

The composite score standard combines different measures of fundamental elements of financial health to yield a single measure of a school’s overall financial health. This method allows financial strength in one area to make up for financial weakness in another area. In addition, this method provides an equitable measure of the financial health of schools of different sizes.

The composite score methodology takes into account the differences between proprietary schools and private nonprofit schools. The variance takes into account the accounting differences between these sectors of postsecondary schools. However, the basic steps used to arrive at the composite score are the same. These steps are described later in this section.

Refund reserve standards

One of the standards that a school must satisfy to be considered financially responsible is that it must have sufficient cash reserves to return FSA funds when a student withdraws. A school is considered to have sufficient cash reserves if it:

- is located in a state that has an ED-approved tuition recovery fund and the school contributes to that fund, or
- for its two most recently completed fiscal years, the school made all required returns in a timely manner (see *Volume 5, Chapter 2* for more information on returns, including timely payment).

Tuition recovery funds

When a state submits a tuition recovery fund for approval by the Department, the Department will consider the extent to which the recovery fund:

- provides returns to both in-state and out-of-state students;
- complies with FSA requirements for the order of return of funds to sources of assistance; and
- is replenished if any claims arise that deplete the fund.

Calculating a composite score

The first step in calculating a school's composite score is to determine the school's primary reserve, equity, and net income ratios by using information from the school's audited financial statement. These ratios take into account the total financial resources of the school. The Primary Reserve Ratio represents a measure of a school's viability and liquidity. The Equity Ratio represents a measure of a school's capital resources and its ability to borrow. The Net Income Ratio represents a measure of a school's profitability.

Upon review, some items from a school's audited financial statement may be excluded from the calculation of the ratios. For example, the Department may exclude the effects of questionable accounting treatments, such as excessive capitalization of marketing costs, from the ratio calculations. (See the regulatory exclusions below.)

All long-term debt obtained for the school's purposes may be included for purposes of the Primary Reserve Ratio calculation. However, it is important to note that the overall level of debt obtained for long-term purposes that can be included in the numerator of the Primary Reserve Ratio is limited under the regulations. It cannot exceed the amount of the school's net property, plant, and equipment.

A strength factor score is then calculated for each ratio using equations established by the Department. A strength factor score reflects a school's relative strength or weakness in a fundamental element

of financial health, as measured by the ratios. Specifically, the strength factor scores reflect the extent to which a school has the financial resources to: 1) replace existing technology with newer technology; 2) replace physical capital that wears out over time; 3) recruit, retain, and retrain faculty and staff (human capital); and 4) develop new programs.

A weighting percentage is applied to each strength factor score to obtain a weighted score for each ratio. The weighting percentages reflect the relative importance that each fundamental element has for a school in a particular sector (proprietary or private nonprofit).

The sum of the weighted scores equals the school's composite score. Because the weighted scores reflect the strengths and weaknesses represented by the ratios and take into account the importance of those strengths and weaknesses, a strength in the weighted score of one ratio may compensate for a weakness in the weighted score of another ratio.

Once a composite score is calculated, it is measured along a common scale from negative 1.0 to positive 3.0 as indicated in the diagram on page 72. This scale reflects the probability a school will be able to continue operations and meet its obligations to students and the Department.

Exclusions

Excluded items. In calculating an institution's ratios, the Secretary—

- (1) Generally excludes extraordinary gains or losses, income or losses from discontinued operations, prior period adjustments, the cumulative effect of changes in accounting principles, and the effect of changes in accounting estimates;
- (2) May include or exclude the effects of questionable accounting treatments, such as excessive capitalization of marketing costs;
- (3) Excludes all unsecured or uncollateralized related-party receivables;
- (4) Excludes all intangible assets defined as intangible in accordance with generally accepted accounting principles; and

(5) Excludes from the ratio calculations Federal funds provided to an institution by the Secretary under program authorized by the HEA only if—

- (i) In the notes to the institution's audited financial statement, or as a separate attestation, the auditor discloses by name and CFDA number, the amount of HEA program funds reported as expenses in the Statement of Activities for the fiscal year covered by that audit or attestation; and
- (ii) The institution's composite score, as determined by the Secretary, is less than 1.5 before the reported expenses arising from those HEA funds are excluded from the ratio calculations.

34 CFR 172(c)

Deposit to operating account or separate federal bank account

A school that maintains a separate federal bank account must deposit to that account, or transfer from its operating account to its federal account, the amount of unearned program funds, as determined under the Return of Title IV funds regulations. The date the school makes that deposit or transfer is the date used to determine whether the school returned the funds within the 45-day timeframe permitted in the regulations.

Unless the Department requires a school to use a separate account, the school may use its operating account for FSA purposes. In this case the school must designate that account as its federal bank account and have an auditable system of records showing that the funds have been allocated properly and returned in a timely manner. If there is no clear audit trail, the Department can require the school to begin maintaining FSA funds in a separate bank account.

34 CFR 668.163(a)

Return of Title IV funds

The requirements for return of Title IV funds for students who withdraw from the educational program are described in *Volume 5*.

Making new awards with returned funds

After a school has returned unearned funds to its federal account, provided those funds were originally received from the Department or from an FFEL lender under a process that allows the school to reuse the unearned funds, the school can use the funds to make disbursements to other eligible students.

Address for Letters of Credit

Letters of credit are submitted to:

Director
Performance Improvement & Procedures
U.S. Department of Education
Federal Student Aid
830 First Street, NE
UCP-3, MS 5435
Washington, DC 20002-8019

Returning funds in a timely manner

Unearned funds must be returned no later than 45 days after the date of the school's determination that the student withdrew. ED considers the school to have returned funds, depending upon the method it uses to return them. Specifically, the regulations provide that a school has returned funds when it has:

- deposited or transferred the funds into the bank account it maintains for federal funds (see sidebar) no later than 45 days after the date it determines that the student withdrew,
- initiated an electronic funds transfer (EFT) no later than 45 days after the date it determines that the student withdrew, or
- issued a check no later than 45 days (as supported by the school's records) after the date it determines that the student withdrew.

If a check is used to return unearned funds, the Department requires that the check be endorsed by ED no later than 60 days after the school's determination that a student withdrew to be considered a timely return.

Compliance thresholds for timely return of funds

The Department provides for a small margin of error in determining that a school has paid all required refunds and returns on time. The Department considers a school to have paid returns in a timely manner if—

- there is less than a 5% error rate in a sample of returns (composed of students for whom the school was required to return unearned funds) examined in a compliance audit, an audit conducted by the Office of the Inspector General (OIG), or a program review conducted by the Department or guaranty agency, or
- there are no more than two late returns in the sample (regardless of the number or percentage of late returns in the sample).

In addition, if the reviewer or auditor finds a material weakness or reportable condition in the school's report on internal controls relating to the return of unearned Title IV aid, the Department considers the school to have not paid returns in a timely manner.

Letter of credit required when funds are not returned in timely manner

Public schools and schools covered by a state tuition recovery fund that has been approved by the Department are not subject to the letter of credit requirements. If any other school exceeds the compliance thresholds in either of its two most recently completed fiscal years, the school must submit an irrevocable letter of credit acceptable and payable to the Department. The letter of credit must be equal to 25% of the returns the school made or should have made during its most recently completed fiscal year.

A school that is required to submit a letter of credit must do so no later than 30 days after the earlier of the date that:

- the school is required to submit its compliance audit;
- the OIG issues a final audit report;
- the designated department official issues a final program review determination;
- the Department issues a preliminary program review report or draft audit report, or a guaranty agency issues a preliminary report showing that the school did not return unearned funds for more than 10% of the sampled students; or
- ED sends a written notice to the school requesting the letter of credit that explains why the school has failed to return unearned funds in a timely manner.

If the finding in the preliminary report is that the school did not return unearned funds in a timely manner for 10% or fewer of the sampled students, a school would generally be required to submit the letter of credit only if the final report shows that the school did not return unearned funds in a timely manner for 5% or more of all the students in the sample. If the final report indicates that a letter of credit is required, the school would have to submit it no later than 30 days after the final report is issued.

Exceptions to the letter of credit requirement

A school is not required to submit a letter of credit of less than \$5,000. However, to meet the reserve requirement, such a school would need to demonstrate that it has available at all times cash reserves of at least \$5,000 to make required returns.

In addition, a school may delay submitting a letter of credit while it asks for reconsideration of a finding that it failed to return unearned FSA funds in a timely manner. A school may request that the Department reconsider its finding if the school submits documents showing that:

- the unearned FSA funds were not returned in a timely manner solely because of exceptional circumstances beyond the school's control and that the school would not have exceeded the applicable threshold had it not been for the exceptional circumstances; or
- it did not fail to make timely returns.

A school that submits an appeal, together with all required supporting documents, by the date the letter of credit would be due is not required to submit a letter of credit unless the Department notifies the school that its request has been denied.

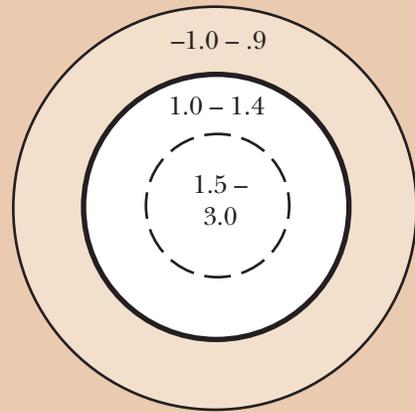
Current in debt payments

A school is not current in its debt payments if

- it is in violation of any existing loan agreement at its fiscal year end, as disclosed in a note to its audited financial statements or audit opinion, or
- it fails to make a payment in accordance with existing debt obligations for more than 120 days, and at least one creditor has filed suit to recover funds under those obligations.

Composite score scale

- 1.5 to 3.0** Financially responsible without further oversight.
- 1.0 to 1.4** In the “Zone.” The school is considered financially responsible, but additional oversight is required.
- 1.0 to .9** Not financially responsible. The school must submit a letter of credit of at least 50% of its FSA funding. The school may be permitted to participate under provisional certification with a smaller letter of credit—with a minimum of 10% of its FSA funding and additional oversight.



Example: Calculation of a composite score for a proprietary institution*

Calculation of Ratios

$$\text{Primary Reserve Ratio} = \frac{\text{Adjusted equity}}{\text{Total expenses}} = \frac{\$760,000}{\$9,500,000} = 0.080$$

$$\text{Equity Ratio} = \frac{\text{Modified equity}}{\text{Modified expenses}} = \frac{\$810,000}{\$2,440,000} = 0.332$$

$$\text{Net Income Ratio} = \frac{\text{Income before taxes}}{\text{Total revenues}} = \frac{\$510,000}{\$10,010,000} = 0.051$$

Calculation of Strength Factor Score

$$\text{Primary Reserve Strength Factor Score} = 20 \times \text{Primary Reserve Ratio} \\ 20 \times 0.080 = 1.600$$

$$\text{Equity Strength Factor Score} = 6 \times \text{Equity Ratio} \\ 6 \times 0.332 = 1.992$$

$$\text{Net Income Strength Factor Score} = 1 + (33.3 \times \text{Net Income Ratio}) \\ 1 + (33.3 \times 0.051) = 2.698$$

Calculation of Weighted Score

$$\text{Primary Reserve Weighted Score} = 30\% \times \text{Primary Reserve Strength Factor Score} \\ 0.30 \times 1.600 = 0.480$$

$$\text{Equity Weighted Score} = 40\% \times \text{Equity Strength Factor Score} \\ 0.40 \times 1.992 = 0.797$$

$$\text{Net Income Weighted Score} = 30\% \times \text{Net Income Strength Factor Score} \\ 0.30 \times 2.698 = 0.809$$

Composite Score

$$\text{Sum of All Weighted Scores} \quad 0.480 + 0.797 + 0.809 = 2.086 \quad \text{rounded to 2.1}$$

* The definition of terms used in the ratios and the applicable strength factor algorithms and weighting percentages are found in the Student Assistance General Provisions (regulations) (34 CFR 668) Subpart L, Appendix A for proprietary schools and Appendix B for private nonprofit schools.

ALTERNATIVES TO THE GENERAL FINANCIAL STANDARDS

If a school does not meet the general standards for financial responsibility, the Department may still consider the school to be financially responsible or may allow the school to participate under provisional certification if the school qualifies for an alternative standard.

If the Department determines that a school that does not meet one or more of the general standards and does not qualify for an alternative, the Department may initiate a limitation, suspension, or termination action against the school (see *Chapter 9* for more information on corrective actions and sanctions).

Letter of credit alternative for new school

A new school (a school that seeks to participate in the FSA programs for the first time) that does not meet the composite score standard (i.e., has a composite score of less than 1.5) but meets all other standards may demonstrate financial responsibility by submitting an irrevocable letter of credit to the Department. The letter of credit must be acceptable and payable to the Department and equal to at least 50% of the FSA program funds that the Department determines that the school will receive during its initial year of participation.

Letter of credit alternative for participating school

A participating proprietary or private nonprofit school that fails to meet one or more of the general standards or is not financially responsible because it has an adverse audit opinion may demonstrate financial responsibility by submitting an irrevocable letter of credit to the Department. The letter of credit must be acceptable and payable to the Department and equal to at least 50% of the FSA program funds that the school has received during its most recently completed fiscal year. The school is then considered to be financially responsible.

Zone alternative

A participating school that fails to meet the composite score standard (i.e., has a composite score of less than 1.5) but meets all other standards may demonstrate financial responsibility for up to three consecutive fiscal years if the Department determines that the school's composite score is equal to 1.0 to 1.4 for each of those years and the school meets specific monitoring requirements.

This alternative gives a school the opportunity to improve its financial condition over time without requiring the school to post a letter of credit or participate under provisional certification. Under the zone alternative, a school's operations, including its administration of the FSA programs, are monitored more closely. If a school does not score at least 1.0 in one of the three subsequent fiscal years or does not improve its financial condition to attain a composite score of at least 1.5 by the end of the three-year period, the school must satisfy another alternative standard to continue participating. In addition, if a school fails to comply with the information reporting or payment method requirements, the Department may determine that the school no longer qualifies under this alternative.

Alternative standards and requirements

34 CFR 668.175

Information to be provided under the zone alternative

The school must provide timely information regarding any of the following oversight and financial events:

- Any adverse action, including a probation or similar action, taken against the institution by its accrediting agency;
- Any event that causes the institution, or related entity as defined in the *Statement of Financial Accounting Standards (SFAS) 57*, to realize any liability that was noted as a contingent liability in the institution's or related entity's most recent audited financial statement;
- Any violation by the institution of any loan agreement;
- Any failure of the institution to make a payment in accordance with its debt obligations that results in a creditor filing suit to recover funds under those obligations;
- Any withdrawal of owner's equity from the institution by any means, including by declaring a dividend; or
- Any extraordinary losses, as defined in accordance with Accounting Principles Board (APB) Opinion No. 30.

The school may also be required to:

- submit its financial statement and compliance audits earlier than the time specified under 34 CFR 668.23(a)(4); and
- provide information about its current operations and future plans.

34 CFR 668.175(d)(2)

Under the zone alternative, a school—

- must request and receive funds under the cash monitoring or reimbursement payment methods, as specified by the Department (see *Volume 4, Chapter 2*);
- must provide timely information regarding certain oversight and financial events (see sidebar);
- may be required to submit its financial statement and compliance audit earlier than normally required (see the discussion of audit submission deadlines earlier in this chapter); and
- may be required to provide information about its current operations and future plans.

The school must also require its auditor to express an opinion, as part of the school’s compliance audit, on the school’s compliance with the requirements of the zone alternative, including the school’s administration of the payment method under which the school received and disbursed FSA program funds.

Provisional certification for school not meeting standards

If a participating proprietary or private nonprofit school fails to meet one or more of the general standards or is not financially responsible because it has an unacceptable audit opinion, the Department may permit the school to participate under provisional certification for up to three years.

The Department may permit a school that is not financially responsible to participate under provisional certification if the school is not financially responsible because it:

- does not satisfy the general standards;
- has an unacceptable audit opinion; or
- has a past performance problem that has been resolved.

If the Department permits a school to participate under provisional certification, the Department will require the school:

- to submit to the Department a letter of credit, payable and acceptable to the Department, for a percentage (10%–100%) of the FSA program funds received by the school during its most recent fiscal year.
- to demonstrate that it has met all of its financial obligations and was current on its debt payments for its two most recent fiscal years.

Moreover, the school must comply with the requirement under the zone alternative that it provide timely information regarding certain oversight and financial events. Finally, a school that is required to post a letter of credit will be placed on heightened cash monitoring or reimbursement.

If a school is still not financially responsible at the end of a period of provisional certification, the Department may again permit provisional certification. However, the Department may require the school or persons or

entities that exercise substantial control over the school to submit financial guarantees to the Department to satisfy any potential liabilities arising from the school's FSA program participation. The same persons may be required to agree to be jointly and severally liable for any FSA program liabilities.

The Department is not required to offer provisional certification to a school. It is an alternative that the Department may choose to offer in exceptional circumstances.

Provisional certification for school where persons or entities owe liabilities

If a school is not financially responsible because the persons or entities that exercise substantial control over the school owe an FSA program liability, the Department may permit the school to participate under provisional certification if:

- the persons or entities that owe the liability repay or enter into an agreement with the Department to repay the liability (or the school assumes the liability and repays or enters into an agreement to repay the liability);
- the school meets all the general standards of financial responsibility and demonstrates that it has met all of its financial obligations and was current on its debt payments for its two most recent fiscal years; and
- the school submits to the Department a letter of credit, payable and acceptable to the Department, for an amount determined by the Department (at least 10% of the FSA program funds received by the school during its most recent fiscal year).

The school also must comply with the requirements under the zone alternative.

In addition, the Department may require the school or persons or entities that exercise substantial control over the school to submit financial guarantees to the Department to satisfy any potential liabilities arising from the school's FSA program participation. The same persons may be required to agree to be jointly and severally liable for any FSA program liabilities.

Notifying the Department of change of control

A school must report any changes of control under which a person acquires the ability to affect substantially the actions of the school. Such changes in control trigger a review to determine if the school is financially responsible (see *Chapter 5*).

PAST PERFORMANCE & AFFILIATION STANDARDS

In addition to meeting the numeric standards of financial responsibility and fulfilling all its financial obligations, a school must demonstrate that it properly administers the FSA programs in which it participates. Past actions of the school or individuals affiliated with the school may reveal mismanagement of FSA program funds, thereby demonstrating that a school is not financially responsible. Therefore, in evaluating the way a school administers the FSA programs, the Department considers the past performance of both the school and individuals affiliated with the school.

Past performance of a school

A school is not financially responsible if it—

- in the last five years, has been subject to a limitation, suspension, or termination action or has entered into an agreement to resolve a limitation, suspension, or termination action initiated by the Department or a guaranty agency;
- in either of its two most recent FSA program reviews or audits, has had findings for the current fiscal year or two preceding fiscal years that required repayment of more than 5% of the FSA program funds received by the school;
- has been cited during the last five years for failing to submit audits as required; or
- has failed to satisfactorily resolve any compliance issues identified in program reviews or audit reports, upheld in a final decision of the Department.

Past performance of persons affiliated with a school

A school is not financially responsible if any person who exercises substantial control over the school (or any members of the person's family alone or together) owes a liability for an FSA program violation or has ever exercised substantial control over another school (or a third-party servicer) that owes a liability for an FSA program violation, unless that person, family member, school, or servicer demonstrates that the liability is being repaid in accordance with an agreement with the Department.

The Department may consider a school that does not meet this requirement to be financially responsible if the school:

- notifies the Department that the individual repaid to the Department an acceptable portion of the liability, in accordance with the regulations;
- notifies the Department that the liability is currently being repaid in accordance with a written agreement with the Department; or
- demonstrates to the satisfaction of the Department: (1) why the person who exercises substantial control should nevertheless be considered to lack that control, or (2) why the person who exercises substantial control and each member of that person's family does not or did not exercise substantial control over the school or servicer that owes the liability.

LIMITATIONS

An otherwise eligible institution becomes an ineligible institution if the school exceeds

- the 50% limit on students without a high school diploma or equivalent,
- the incarcerated student limitation (25%), or
- the correspondence course limitation (50%) or the correspondence student limitation (50%).

A school must calculate these percentages to demonstrate compliance with a requirement or to demonstrate eligibility for a limitation waiver. For each of the tests, the calculation performed by the school must be attested to by the independent auditor who prepares the school's audited financial statement or its FSA compliance audit. If a school's initial or previous calculation was in error, the auditor's report must be part of the audit workpapers and must include a recalculation. The auditor's attestation report must indicate whether the school's determinations (including any relevant waiver or exception) are accurate.

For each of the limitation requirements, the school must notify the Department (via Section G of the E-App) of the school's failure to meet a requirement, its falling within a prohibited limitation, or its ineligibility for a continued waiver, as applicable. The school's notification must occur by July 31 following the end of an award year. A school that fails to meet any of these requirements loses its eligibility to participate in any FSA program as of the last day of the most recent award year for which the school failed to meet the requirement.

If a school loses its eligibility because it failed to meet one or more of the limitation requirements, the school cannot regain eligibility until it can demonstrate that it was in compliance with all of the limitation requirements for the most recently completed award year. Once this has occurred the school may apply to regain its eligibility. In addition, it must also show how its administrative practices and policies have been changed to ensure that it will not fall within prohibited limits in the future.

Limitation on students admitted without a high school diploma or equivalent

A school that does not provide a 4-year bachelor's degree program or a 2-year associate degree program is ineligible if, for its latest complete award year, more than 50% of its regular enrolled students had neither a high school diploma nor its equivalent.

If a public or private nonprofit institution exceeds the 50% limit because it serves significant numbers of these students through contracts with federal, state, or local government agencies, the Department may waive the limitation.

The waiver will only be granted if no more than 40% of the public or private nonprofit regular students not served through contracts with federal, state, or local government agencies to provide job training do not have a high school diploma or its equivalent. If granted, the waiver may be extended

Conditions of institutional ineligibility

34 CFR 600.7

In addition to the limitations discussed in this chapter, a school is not eligible if it (or its owner) files for bankruptcy or if the school, its owner, or its CEO is responsible for a crime involving FSA program funds. See chapters 1 and 3.

A school that becomes ineligible because of one of these factors must immediately stop awarding FSA funds and must follow the requirements for a school that has lost its FSA participation (see *Chapter 9*).

Incarcerated student definition

A student who is serving a criminal sentence in a federal, state, or local penitentiary, prison, jail, reformatory, work farm, or other similar correctional institution (this does not include detention in a halfway house, home detention, or weekend-only sentences).

Waiver of incarcerated student limitation

→ For a public or private nonprofit school offering only two-year or four-year programs that lead to associate or bachelor's degrees, the waiver applies to all programs offered at the school.

→ However, if the public or private nonprofit school offers other types of programs, the waiver would apply to any of the school's two-year associate degree programs or four-year bachelor's degree programs, and also to any other programs in which the incarcerated regular students enrolled have a 50% or greater completion rate. (The calculation of this completion rate is specified in 34 CFR 600.7(e)(2) of the Institutional Eligibility regulations and must be attested to by an independent auditor.)

→ A nonprofit school may request the waiver using the E-App (<http://www.eligcert.ed.gov>), by answering the questions in "Section G" and explaining in "question 69."

Limitations on incarcerated students & correspondence study

Incarcerated students

34 CFR 600.7(a)(1)(iii) and 600.7(c)

Correspondence study

Sec. 481(a)(3)(A) and (B) of the HEA

34 CFR 600.7(a)(1)(i) and (ii)

Correspondence student eligibility

For information about a student's eligibility for FSA funds while enrolled in a correspondence course and cost of attendance information for correspondence courses, see *Volume 1, Chapter 1* and *Volume 3, Chapter 2*.

A school is the sum only of its eligible programs

Some postsecondary institutions offer programs that are eligible for FSA as well as programs that are not FSA-eligible. For FSA program purposes, we consider an eligible institution is the sum of its "eligible programs."

To minimize the effect on its institutional eligibility of offering programs solely by correspondence that do not lead to a degree, a school might choose to identify those programs as not part of its FSA-eligible programs.

A program (and students enrolled therein) that was so identified would not be considered part of the school in these two formulas.

Notifying ED when limit is exceeded

34 CFR 600.7(h)

If there is a change to any of a school's answers to the Yes/No questions in Section G of a submitted Electronic Application (E-App) (which deal with enrollment thresholds in these areas), the school must notify the Department via the E-App (see *Chapter 5*).

The Department will advise the school of its options, including whether the school might be eligible for a waiver. (Waivers are available for the correspondence student limitation, the incarcerated student limitation, and the limitation on students without a high school diploma or equivalent.)

Carl D. Perkins Career and Technical Education Act of 2006

20 U.S.C. 2301

in each year the public or private nonprofit school continues to meet the requirements. The public or private nonprofit school's calculation must be attested to by an independent auditor.

Incarcerated student limitation

A school is ineligible if, in its latest complete award year, more than 25% of its regular students are incarcerated. A public or private nonprofit school can ask the Department to waive this limitation (see sidebar for details). If granted, the waiver is effective as long as the public or private nonprofit school continues to meet the waiver requirements each award year. For information on the eligibility of incarcerated students for FSA assistance, see *Volume 1, Chapter 1*.

Correspondence course & correspondence student limitation

In general, a school is ineligible if, for the latest complete award year—

- more than 50% of the school's courses were correspondence courses (correspondence course limitation).

Note: This limitation does not apply to a school that mainly provides vocational adult education or job training (as defined under Sec. 521(4)(C) of the Carl D. Perkins Vocational and Applied Technology Education Act).

- 50% or more of the school's regular enrolled students were enrolled in correspondence courses (correspondence student limitation).

This limitation may be waived for a school that offers a 2-year associate degree or 4-year baccalaureate degree program if the school demonstrates to the Department that in that award year, the students enrolled in its correspondence courses receive no more than 5% of the total FSA program funds received by all of the school's students in the award year.

Note that the 50% limits apply to the school, not to its individual programs. An educational program composed entirely of correspondence courses could still be an eligible program if no more than 50% of the school's courses were offered through correspondence and the program met other eligibility requirements.

This limitation may be waived for a 2-year associate or 4-year baccalaureate degree program if the school can demonstrate to the Department that students enrolled in correspondence courses received no more than 5% of the total FSA program funds awarded to its students in the award year. Also note that the limitations on correspondence courses and correspondence students do not apply to a school that mainly provides vocational adult education or job training (as defined under section 3(3C) of the Carl D. Perkins Vocational and Applied Technology Education Act of 1995).

The school's correspondence course calculation and correspondence student calculation must be attested to by an independent auditor.

For additional information on correspondence study in the context of program eligibility, see *Chapter 2*.

Calculating the percentage of correspondence courses

- If a school offers a course both by correspondence and residential training, the course counts twice, as a correspondence course and as a residential course. Thus, it would count as one in the numerator and as two in the denominator.
- Regardless of how many sections of a course or program are offered during the award year (as a residential or as a correspondence course), the course is counted only once under each type.
- A program not offered in courses or modules counts as one correspondence course.

Using the latest complete award year, the formula for determining the percentage of correspondence courses is as follows:

$$\frac{\text{number of school's correspondence courses}}{\text{total number of school's courses}} = \% \text{ of correspondence courses}$$

Calculating the percentage of correspondence students

- All enrolled regular students must be counted. (A regular student is “a person enrolled for the purpose of obtaining a degree, certificate, or other recognized educational credential offered by the school.”)
- A school must use a straight head count of enrolled students, including full-time and part-time students and students who don't receive aid as well as FSA recipients.
- If a student withdrew from the school and received a full refund the student is not counted.

Using the latest complete award year, the formula for determining the percentage of enrolled students is as follows:

$$\frac{\text{number of regular students enrolled in the school's correspondence courses}}{\text{number of regular students enrolled in all of the school's courses}} = \% \text{ of correspondence students}$$

The eCDR process

ED sends the draft and official cohort default rates electronically to all schools participating in the FSA Programs. You must enroll in the eCDR process to receive your rates. If your school is not enrolled, go to www.fsawebenroll.ed.gov On that page choose “Enroll” and then select the radio button for “Modify Existing Services for a Destination Point.”

Default rates on the Web

Searchable default rates for all schools participating in the FSA programs are posted on the Web at www.ed.gov/FSA/defaultmanagement

The Department also publishes *Budget Lifetime Default Rates* and *Cumulative Lifetime Default Rates* for the FFEL and Direct Loan Programs. These rates, which include additional defaults in years after the close of the CDR “default window,” do not affect a school’s eligibility.

Default rates and suspension

34 CFR Part 668

- Calculation of rates
 - Subpart M Two-Year Cohort Default Rates
 - Subpart N Cohort Default Rates
- Consequences of default rates
 - 34 CFR 668.16(m)

CDR calculation and sanctions in the law
HEA: Sec. 435(m)
20 U.S.C. 1082, 1085, 1094, 1099c

Cohort Default Rate Guide

For more technical information on default rates and procedures for challenges, adjustments, and appeals, please refer to the *Cohort Default Rate Guide*.

ifap.ed.gov/DefaultManagement/finalcdrg.html

School Participation Team contacts

You can locate the School Participation Team for your region by going to the “Help” menu on the IFAP website and choosing *Contact Information > Federal Student Aid Offices*.

COHORT DEFAULT RATES

A school’s eligibility for the FSA programs can be affected by a high cohort default rate (CDR). The Department calculates a school’s CDR based on information from the loan holders, including private lenders (for FFEL), schools (for Perkins), and the Direct Loan servicers.

The Department sends draft default rates to participating schools in February to allow each school an opportunity to review and correct the data that will be used to calculate its official cohort default rates. In September of each year, the Department issues the official cohort default rates. These rates are electronically delivered to schools and posted on the Web. Your school must be enrolled in the eCDR process for electronic delivery of the rates (see sidebar note for instructions and appeal procedures).

Time frames for cohort default rates

A school’s annual CDR is based on a “cohort” of students who received FFEL or Direct Loans at your school and entered repayment in a single fiscal year. The fiscal year that is used is the federal fiscal year (October 1–September 30).

For instance, your school’s FY 2009 CDR is based on the cohort of students who received FFEL or Direct Loans at your school and entered repayment on those loans between October 1, 2008, and September 30, 2009. This number becomes the denominator (the lower part of the fraction) in the CDR calculation.

$$\frac{\text{X}}{\text{Total borrowers who enter repayment during FY2009}}$$

The Department tracks this group of students during the fiscal year in which they enter repayment, and through the end of the following fiscal year. The sum of students who default on their loans (or meet other related conditions) during those two fiscal years become the numerator (top part of the fraction) in the CDR calculation.

$$\frac{\text{Total borrowers who entered repayment in FY2009 who defaulted in FY2009 and 2010}}{\text{Total borrowers who entered repayment during FY2009}}$$

Because it takes two years to track the outcomes, the initial FY 2009 CDR for your school is not released until two years later, at the beginning of 2011. This is one of the reasons that your school should closely monitor student borrowing and implement effective default prevention procedures as soon as possible. The steps you take to help your students this year may reduce the number of defaults in your school’s CDR two years down the road.

The terminology, criteria, calculations, and exceptions for the rates are described in more detail in the *Cohort Default Rate Guide*.

Change to 3-year time frame for FY2009 cohort default rates

Beginning with the cohort of students who enter repayment in FY 2009 (October 1, 2008–September 30, 2009), schools will receive both a two- and three-year cohort default rate. Cohort default rates will now be calculated as

the percentage of borrowers in the cohort who default before the end of the second fiscal year following the fiscal year in which the borrowers entered repayment. Schools will continue to receive two rates until 2014 when the 2011 three-year cohort default rates are released.

No sanctions will be applied to schools based on the new rates until three annual rates have been calculated. As stated, this will occur in 2014. However, if a school's FY 2009 three-year cohort default rate is equal to or greater than 30 percent, the school must establish a default prevention task force that prepares a plan to identify the factors causing cohort default rates to exceed 30 percent, and the school must submit the plan to the Department for review. During this transition period, sanctions will be based on the two-year cohort default rate described in the previous section.

Effect of cohort default rates

Currently a school is not considered to be administratively capable when

- the cohort default rate for Perkins loans made to students for attendance at the school exceeds 15% (see *Volume 6* for details), or
- the cohort default rate for Federal Stafford/SLS loans or for Direct Subsidized/Unsubsidized Loans made to students for attendance at the school equals or exceeds 25% for the three most recent fiscal years, or if the most recent cohort default rate is greater than 40%.

When a high default rate demonstrates a lack of administrative capability, the Department may choose to provisionally certify such a school.

In addition to affecting a school's administrative capability and limiting the school's participation in the FSA programs, a high default rate may make a school ineligible to participate in the Direct Loan, Pell Grant, or Perkins programs. For detailed information on default requirements refer to the *Cohort Default Rate Guide* (posted on IFAP—see sidebar).

Default prevention & management plan

If your school's cohort default rate is equal to or greater than 30%, it must establish a default prevention task force that prepares a plan that—

- identifies the factors causing your cohort default rate to exceed the threshold,
- establishes measurable objectives and the steps your school will take to improve your cohort default rate, and
- specifies the actions your school will take to improve student loan repayment, including counseling students on repayment options.

You must submit your default prevention plan to your School Participation Team for review (see sidebar for contact). If your cohort default rate is equal to or greater than 30% for two consecutive fiscal years, you must revise your default prevention plan and submit it to us for review.

Contacting the default office

The Operations Performance Division in Federal Student Aid responds to questions about FFEL/DL cohort default rates, and reviews FFEL/DL cohort default rate challenges, adjustments, and appeals. It also provides technical assistance and outreach to schools to assist them in lowering their default rates.

Web: ifap.ed.gov/DefaultManagement

Hotline: 202-377-4259

FAX: 202-275-0913

E-MAIL: fsa.schools.default.management@ed.gov

Default prevention & management plan

34 CFR 668.217

See <http://www.ifap.ed.gov/DefaultPreventionResourceInfo/index.html>

for more information.

Default prevention & management plan for new schools

New schools are required to implement a default prevention and management plan prior to certification. In addition, a school that undergoes a change in ownership that results in a change in control or a school that changes its status as a main campus, branch campus, or additional location must also implement a default management plan.

Schools applying to participate are exempt from submitting a default plan if—

- the school, including its main campus and any branch campus, does not have a cohort default rate greater than 10%, and
- the new owner of the school does not own and has not owned any other school that had a cohort default rate greater than 10% during the owner's tenure.

Sample Default Plan

A "Sample Default Prevention and Management Plan" was issued as an attachment to GEN-05-14. The sample plan is also posted in the collection of "Default Rate Materials" on the IFAP website.

