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# Financial Responsibility

*In this chapter, we discuss the financial responsibility requirements for all schools participating in the FSA programs.*

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**I**n order 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. See chapter 11 for more information on required audit submissions.

What follows is a general overview of the financial responsibility standards. Schools should refer to Subpart L of the Student Assistance General Provisions for complete information. For information regarding accounting and compliance issues, a school should contact its Case Management Team (see chart at the end of chapter 11).

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 program 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.

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## Financial responsibility cites

Sec. 498(c)

34 CFR 668 Subpart L

## GENERAL STANDARDS

### *Proprietary or private nonprofit institution*

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

- 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 current in its debt payments, and
- 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.

These requirements are discussed in more detail below.

### Audit opinions and past performance

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

- the school has a statement by the auditor in its audited financial statement expressing doubt about the continued existence of the school as a *going concern* or has an adverse, qualified, or disclaimed opinion (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 below.

### Composite score

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#### Ratios cite

34 CFR 668.171(b)(3)

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.

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

The composite score methodology takes into account the differences between proprietary institutions and private nonprofit institutions. The variance takes into account the accounting differences between these sectors of postsecondary institutions.

However, the basic steps used to arrive at the composite score are the same. 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 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. You can find more information on possible exclusions in 34 CFR 668.172(c). In addition, the Department has issued additional guidance on the treatment of *long-term* and other debt in calculating these ratios. You can find that guidance in DC-GEN-01-02.

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.

The example below illustrates the calculation of a composite score for a proprietary institution.

## Example of a Calculation of a Composite Score for a Proprietary Institution\*

### Calculation of Ratios

Primary Reserve Ratio	=	$\frac{\text{Adjusted Equity}}{\text{Total Expenses}}$	=	$\frac{\$760,000}{\$9,500,000}$	=	0.080
Equity Ratio	=	$\frac{\text{Modified Equity}}{\text{Modified Assets}}$	=	$\frac{\$810,000}{\$2,440,000}$	=	0.332
Net Income Ratio	=	$\frac{\text{Income Before Taxes}}{\text{Total Revenues}}$	=	$\frac{\$510,000}{\$10,010,000}$	=	0.051

### Calculation of Strength Factor Score

Primary Reserve Strength Factor Score = 20 x Primary Reserve Ratio

$$20 \times 0.080 = 1.600$$

Equity Strength Factor Score = 6 x Equity Ratio

$$6 \times 0.332 = 1.992$$

Net Income Strength Factor Score = 1 + (33.3 x Net Income Ratio)

$$1 + (33.3 \times 0.051) = 2.698$$

### Calculation of Weighted Score

Primary Reserve Weighted Score = 30% x Primary Reserve Strength Factor Score

$$0.30 \times 1.600 = 0.480$$

Equity Weighted Score = 40% x Equity Strength Factor Score

$$0.40 \times 1.992 = 0.797$$

Net Income Weighted Score = 30% x Net Income Strength Factor Score

$$0.30 \times 2.698 = 0.809$$

### Composite Score

Sum of All Weighted Scores

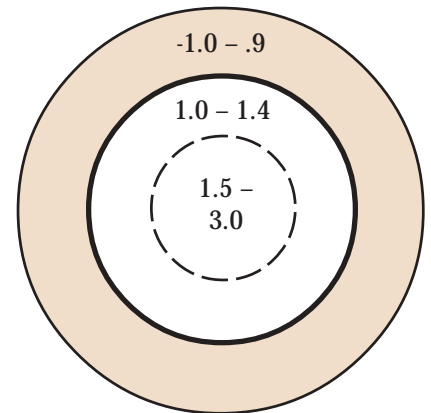
$$0.480 + 0.797 + 0.809 = 2.086 \quad \text{rounded to 2.1}$$

\*The definition of terms used in the ratios and the applicable strength factor algorithms and weighting percentages are found in Appendix A, Subpart L, of the General Provisions for proprietary institutions and Appendix B, Subpart L for private nonprofit institutions.

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 chart below. This scale reflects the probability a school will be able to continue operations and meet its obligations to students and the Department.

### Financial Responsibility Composite Score Scale

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



### Refund reserve standards

Under the provisions of Subpart L of the General Provisions regulations, one of the standards that an institution must satisfy, in order to be considered financially responsible, is that it must have sufficient cash reserves to return Title IV funds as required under 34 CFR 668.22(j) when a student withdraws. An institution is considered to have sufficient cash reserves if it:

- satisfies the requirements of a public school (see the discussion of public schools under *General Standards*); or
- is located in a state that has a tuition recovery fund approved by the Department and the school contributes to that fund; or
- for a student who withdrew, returns unearned Title IV funds in a timely manner.

The Department considers that an institution has sufficient cash reserves if, for its two most recently completed fiscal years, the institution made all required returns in a timely manner, (see chapter 6 for more information on returns, including timely payment).

### Returning funds in a timely manner

Unearned funds must be returned no later than 30 days after the date of the institution's determination that the student withdrew. Revised regulations published November 1, 2002 define when ED considers the institution to have returned funds, depending upon the method it uses to return them.

#### Refund reserve standard cite

34 CFR 668.173

#### For withdrawn students, returns funds in a timely manner cite

34 CFR 668.22

Specifically, the regulations provide that an institution has returned funds when it has:

1. deposited or transferred the funds into the bank account it maintains for federal funds no later than 30 days after the date it determines that the student withdrew;

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### **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 institution to reuse the unearned funds, the school can use the funds to make disbursements to other eligible students.

An institution 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 institution makes that deposit or transfer is the date used to determine whether the institution returned the funds within the 30-day timeframe permitted in the regulations.

Unless the Department requires an institution to use a separate account, the institution may use its operating account for Title IV purposes. In this case, the institution must designate that account as its federal bank account, as required under 34 CFR 668.163(a), 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 institution to begin maintaining Title IV funds in a separate bank account.

2. initiated an electronic funds transfer (EFT) no later than 30 days after the date it determines that the student withdrew,
3. initiated an electronic transaction, no later than 30 days after the date it determines that the student withdrew, that informs an FFEL lender to adjust the borrower's loan account for the amount returned or
4. issued a check no later than 30 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 the bank used by the Department or FFEL Program lender no later than 45 days after the institution's determination that a student withdrew in order to be considered a timely return.



### ***Compliance thresholds***

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 institution was required to return unearned funds) examined in a compliance audit conducted under 34 CFR 668.23, an audit conducted by the Office of the Inspector General, or a program review conducted by the Department or guaranty agency; or
- there are only one or two late returns in the sample (regardless of the number or percentage of late returns in the sample).

If the reviewer or auditor finds a material weakness or reportable condition in the institution's report on internal controls relating to the return of unearned Title IV, HEA program funds, the Department considers the institution to have not paid Returns in a timely manner.

### ***Letter of credit***

Public institutions and institutions covered by a state tuition recovery fund are not subject to the letter of credit requirements. If any other institution exceeds the compliance thresholds in either of its two most recently completed fiscal years, the institution 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 institution made or should have made during its most recently completed fiscal year.

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

1. the institution is required to submit its compliance audit;
2. the Office of the Inspector General issues a final audit report;
3. the designated department official issues a final program review determination;
4. the Department issues a preliminary program review report or draft audit report, or a guaranty agency issues a preliminary report showing that the institution did not return unearned funds for more than 10% of the sampled students; or

**Note:** If the finding in the preliminary report is that the institution did not return unearned funds in a timely manner for 10% or fewer of the



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

5. the Secretary sends a written notice to the institution requesting the letter of credit that explains why the institution has failed to return unearned funds in a timely manner.

Letters of credit are submitted to:

U.S. Department of Education  
Case Management and Oversight  
Data Management and Analysis Division  
Document Receipt and Control Center  
830 First Street, NE  
Room 71-I-1  
Washington, DC 20002-5402



New

#### Exceptions to the letter of credit requirement

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

In addition, an institution may delay submitting a letter of credit while it asks for reconsideration of a finding that it failed to return unearned Title IV, HEA program funds in a timely manner. An institution may request that the Department reconsider its finding if the institution submits documents showing that:

1. the unearned Title IV, HEA program funds were not returned in a timely manner solely because of exceptional circumstances beyond the institution's control and that the institution would not have exceeded the applicable threshold had it not been for the exceptional circumstances; or
2. it did not fail to make timely returns.

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



New



## Tuition Recovery Funds

When a state submits a tuition recovery fund for evaluation 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 program requirements for the order of return of funds to sources of assistance; and
- will be replenished if any claims arise that deplete the fund.

## 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
- 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.

## 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 other 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 separately from the financial statements.

Public schools also must meet the past performance and affiliation standards discussed below. In addition, public schools are required to submit financial statements prepared in accordance with generally accepted accounting principles (GAAP) and prepared on the accrual basis.

A public institution should submit the letter to:

**U.S. Department of Education  
Case Management and Oversight  
Data Management and Analysis Division  
Document Receipt and Control Center  
830 First Street, NE  
Room 71-I-1  
Washington, DC 20002-5402  
Phone (202) 377-3630 (only for this purpose)**

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**Alternative standards and requirements cite**

34 CFR 668.175

## **ALTERNATIVES TO THE GENERAL 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 11 for more information).

### ***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 institution 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.

### ***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.

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 chapter 5);
- must provide timely information regarding certain oversight and financial events (for example, any adverse action taken by the school's accrediting agency);

(Refer to 34 CFR 668.175(d) for more information on specific reporting requirements.)

- may be required to submit its financial statement and compliance audit earlier than normally required (see chapter 11 for more information on audit submission deadlines); 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 institution fails to meet one or more of the general standards or is not financially responsible because it has an adverse 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 adverse 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 an amount determined by the Department. (This amount must be equal to at least 10%

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.

In addition, the school must comply with the requirement under the zone alternative that it provide timely information regarding certain oversight and financial events.

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; in lieu of this, the school may assume the liability and repay or enter into an agreement to repay the liability; and
- the school meets all the general standards of financial responsibility; (In addition, the school must demonstrate 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. (This amount must be equal to at least 10% of the FSA program funds received by the school during its most recent fiscal year.)

The school 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.

## PAST PERFORMANCE AND 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 the school:

- 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, institution, 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 institution or servicer that owes the liability.

In the past, schools were required to maintain fidelity bond coverage for their employees. This is no longer a federal requirement for schools that participate in the FSA programs. However, by state law some schools are still required to maintain fidelity bond coverage. Even if a school is not required to do so, it may choose to maintain fidelity bond coverage to protect itself when losses occur because of a lack of integrity, on the part of the school's employees or officers.

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 10).

## FINANCIAL STATEMENTS

All financial statements are received by the Document Receipt and Control Center (DRCC). The Department screens financial statements it receives, makes a preliminary calculation of a school's composite score, and based on a checklist of minimum requirements, determines whether the statements are materially complete. In some cases a school may receive a more thorough analysis of its financial statements.

For more information regarding audit reporting and submission requirements refer to chapter 11.

## FOREIGN SCHOOLS

Unless a participating foreign school received less than \$500,000 (in United States dollars) in FSA program funds during its most recently completed fiscal year, the school must meet the financial responsibility standards for domestic schools. A foreign school that received \$500,000 or more in FSA program funds during its most recently completed fiscal year must have its audited financial statement

prepared under U.S. Generally Accepted Accounting Principles (GAAP) and Generally Accepted Government Auditing Standards (GAGAS). In addition, the school's financial statement must be submitted in English.

A foreign school that received less than \$500,000 in FSA program funds during its most recently completed fiscal year may have its audited financial statement prepared according to the standards of the school's home country.

