

Financial Responsibility

In this chapter, we discuss the financial responsibility requirements for all schools participating in the SFA Programs.

In order to participate in the SFA 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. The combined submission must be submitted to the Department within six months of the end of the school's fiscal year. See Chapter 11 for more information on required audit submissions.

The Higher Education Amendments of 1998, Public Law 105-244, (the Amendments of 1998) made the following changes to the financial responsibility requirements:

- The criteria used to determine the financial responsibility of a school is revised to be based on whether it meets certain ratios that demonstrate financial responsibility. Previous criteria required the Department to consider operating losses, net worth, asset-to-liabilities ratios, or operating fund deficits.
- Public schools are included with for-profit and nonprofit institutions with respect to taking into consideration differences in generally accepted accounting principles.
- The Department is permitted to determine what third-party financial guarantees are acceptable in order for a school to be considered financially responsible even though it failed to meet other mandated measures of financial responsibility.

NOVEMBER 25, 1997 FINAL REGULATIONS

A notice of proposed rulemaking (NPRM) published September 20, 1996, proposed implementation of new financial responsibility standards. In response to public comment, the comment period on some portions of the NPRM was extended through April 14, 1997.

Financial Responsibility Cites
Sec. 498(c), 34 CFR 668 Subpart L

Amendments
of 1998



Final regulations were published November 25, 1997. These financial responsibility requirements are applicable to schools that submit audited financial statements on or after July 1, 1998. A discussion of the provisions implemented by these final regulations is included here.

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 page 251 for contact information).

The Department determines whether a school is financially responsible based on its ability to

- provide the services described in its official publications and statements,
- administer properly the SFA program in which the school participates, and
- meet all of its financial obligations.



Under the regulations of November 25, 1997, the financial responsibility standards can be divided into two categories: (1) General standards, which are basic standards that are used to evaluate a school's financial health, and (2) Performance and affiliation standards, which are standards that are used to evaluate a school's past performance and to evaluate persons affiliated with the school.

Schools are no longer required to meet standards that apply specifically to each type of school. Instead, differences among sectors of schools (for example, proprietary, private nonprofit, and public) are taken into account by variances within a standard. This change is discussed more fully in the discussion of the new composite score standard.

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 required refunds (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 and making repayments to cover SFA 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 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

In the past, a school had to meet separate tests for assessing the financial condition of the school. The school was required to meet the minimum standard for each separate test. For example, a proprietary school was required to meet an acid test ratio, and standards for tangible net worth and operating losses. A nonprofit school was required to meet an acid test ratio, and standards for measuring unrestricted fund balances or assets, or fund expenditures over fund revenues. The November 25, 1997 final regulations replaced these separate tests for proprietary and private non-profit institutions with a single standard called the composite score standard. 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.



Some aspects of the composite score methodology (for example, the calculation of ratios) vary depending on whether the school is a proprietary institution or a private non-profit institution. 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 F and G of the General Provisions regulations.

The first step in calculation 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 in the ratios established by the Department. These ratios are used to take into account the total financial resources of the school. The primary reserve ratio represents a school’s viability and liquidity. The equity ratio represents a school’s ability to borrow and its capital resources. The net income ratio represents a school’s profitability. 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 34 CFR 668.172(c) for more information on possible exclusions.

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 each of 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 re-train 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 non-profit).

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 x 0.080 = 1.600
Equity Strength Factor Score =	6 x Equity Ratio	6 x 0.332 = 1.992
Net Income Strength Factor Score =	1 + (33.3 x Net Income Ratio)	1 + (33.3 x 0.051) = 2.698
Calculation of Weighted Score		
Primary Reserve Weighted Score =	30% x Primary Reserve Strength Factor Score	0.30 x 1.600 = 0.480
Equity Weighted Score =	40% x Equity Strength Factor Score	0.40 x 1.992 = 0.797
Net Income Weighted Score =	30% x Net Income Strength Factor Score	0.30 x 2.698 = 0.809
Composite Score		
Sum of all weighted scores	0.480 + 0.797 + 0.809 = 2.086 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 F of the General Provisions for proprietary institutions and Appendix G for private nonprofit institutions.		

Once the 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 degree of certainty that a school will be able to continue operations and meet its obligations to students and the Department.

Financial Responsibility Composite Score Scale	
1.5 to 3.0	Financially responsible without further oversight
1.0 to 1.4	Financially responsible if meet the "zone alternative" or 50% or greater letter of credit alternative. May be permitted to participate under provisional certification with smaller letter of credit, but not considered financially responsible.*
-1.0 to .9	Financially responsible if meet the 50% or greater letter of credit alternative. May be permitted to participate under provisional certification with smaller letter of credit, but not considered financially responsible ("zone alternative" not available).*

*Transition year alternative available for one year.

Refund Reserve Standards

A school must have sufficient cash reserves to make any required refunds (see Chapter 6 for more information on refunds, including timely payment of refunds). The Department considers a school to have sufficient cash reserves if the school meets one of the following three criteria:

- satisfies the requirements of a public school (see the discussion of public schools under “General Standards”),
- is located in a state that has a tuition recovery fund approved by the Department and the school contributes to that fund, or
- demonstrates that it make its refunds timely.

A school has made its refunds timely if it can demonstrate, through audits for the two most recent fiscal years, that for the past two years the school has paid all required refunds on time.

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

- there is less than a five percent error rate in the sample of refunds examined by a reviewer or auditor (i.e., the school failed to make timely refunds to less than five percent of the students in the sample), or
- Δ there is only one late refund in the sample of refunds examined by a reviewer or auditor (regardless of the percentage of refunds in the sample represented by the one late refund), and

Δ the reviewer or auditor did not note for either fiscal year a material weakness or a reportable condition in the school's report on internal controls that is related to refunds.

If a finding is made that a school no longer meets any of the three criteria for demonstrating that it has sufficient cash reserves to make any required refunds, the school must post a letter of credit equal to 25% of the total SFA Program refunds made or that should have been made by the school during its most recently completed fiscal year. The school must submit the letter of credit to the Department no later than 30 days after the school is notified of the finding, or no later than 30 days after the school's compliance audit is due, if it was the auditor that conducted the school's compliance audit who determines that the school no longer qualifies. A school must send the letter of credit to

U.S. Department of Education
Institutional Participation and Oversight Service
P.O. Box 23800
L'Enfant Plaza Station
Washington, DC 20026
ATTN: Director, IPOS

In addition to posting the letter of credit, if a guaranty agency or state review determines that the school no longer meets the refund reserve standard, the school must notify the Department of the guaranty agency or state that conducted the review.

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 refunds to both in-state and out-of-state students,
- complies with SFA Program requirements for the order of return of refunds 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.



A public school must also meet the past performance and affiliation standards discussed below. Also, public schools are still subject to the Department's reporting requirements which require the submission of financial statements that are prepared in accordance with generally accepted accounting principles (GAAP) and on the accrual basis.

The letter is a one-time submission and should be submitted as soon as possible separately from the financial statements.

The public institution should submit the letter as follows.

If by U.S. Postal Service:

U.S. Department of Education
Institutional Participation and Oversight Service
P. O. Box 44805
L'Enfant Plaza Station
Washington, D.C. 20026-4805

If by commercial overnight mail/courier delivery:

U.S. Department of Education
Institutional Participation and Oversight Service
7th & D Streets, S.W.
GSA Building, Room 3514
Washington, D.C. 20407

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 also 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).

The alternate standards were changed by the November 25, 1997 final regulations to reflect changes made to the general standards. For example, the “precipitous closure alternative” has been replaced by the “zone alternative.”



LOC alternative for new school

A new school (a school that seeks to participate in the SFA 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 percent of the SFA Program funds that the Department determines that the school would receive during its initial year of participation.

LOC alternative for participating school

A participating proprietary or private nonprofit institution that fails to meet one or more of the general standards or isn't financially responsible because it has of an unacceptable 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 percent of the SFA 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 SFA 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 to participate. 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 this alternative, the school

- must request and receive funds under the cash monitoring or reimbursement payment methods, as specified by the Department (see Chapter 5 for more information);

- must provide timely information regarding certain oversight and financial events (for example, any adverse action taken by the school's accrediting agency). A school should refer to 34 CFR 668.175(d) for more information;
- 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 SFA Program funds.

Transition year alternative

In order to provide schools with an opportunity to prepare for the evaluation of their financial responsibility under the November 25, 1997 standards, a transition period of one year was established. The transition year period varies for each school because it is based on each school's fiscal year. A school's transition year is the school's fiscal year that began on or after July 1, 1997 but on or before June 30, 1998.



During its transition year, a school that has a composite score of less than 1.5 may demonstrate financial responsibility by meeting the general financial responsibility standards that were in effect immediately prior to the November 25, 1997 final regulations. If a school fails to satisfy both the composite score standard and the "old" general financial responsibility standards, the school must meet one of the alternative standards. For any fiscal year that begins on or after the July 1, 1998 effective date of the November 25, 1997 regulations, a school must satisfy the requirements under the November 25, 1997 regulations.

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 unacceptable audit opinion, the Department may permit the school to participate under provisional certification for up to three years. For example, a school with a composite score of less than 1.0 that cannot post the 50 percent letter of credit required for the letter of credit alternative, may be permitted to continue to participate under provisional certification by submitting a smaller letter of credit.

The Department may also permit a school that is not financially responsible because of a condition of past performance of the school to participate under provisional certification for up to three years if the school demonstrates to the Department that it has satisfied or resolved the condition.

A school that participates under provisional certification for a lack of financial responsibility does so under the following conditions

- the school must 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 SFA Program funds received by the school during its most recent fiscal year),
- 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 Department may require the school to comply with the requirement under the zone alternative that the school 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 SFA Program participation. The same persons may be required to agree to be jointly and severally liable for any SFA Program liabilities.

The Department is not required to offer provisional certification to a school. It is an alternative that the Department may offer the school instead of denying an application for recertification.

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 SFA 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;
- the school meets all the general standards of financial responsibility (except that 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 SFA Program funds received by the school during its most recent fiscal year).

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

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 SFA Program participation. The same persons may be required to agree to be jointly and severally liable for any SFA Program liabilities.

Again, provisional certification is offered to a school at the Department's discretion. The Department is not required to offer provisional certification to a school.

PAST PERFORMANCE AND AFFILIATION STANDARDS

As mentioned at the beginning of this chapter, in addition to meeting the numeric standards of financial responsibility, a school must also demonstrate that it administers properly the SFA Programs in which it participates and that it meets all of its financial obligations, including repayments to the department for debts and liabilities. A school's financial responsibility is also evaluated based on the past performance of the school and persons affiliated with the school. Certain past actions of a school or a person affiliated with a school may reveal mismanagement of SFA Program funds, thereby demonstrating that a school is not financially responsible.

Past performance of a school

A school is not financially responsible if the school

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

Family

A member of a person's family is a parent, sibling, spouse, child, spouse's parent or sibling, or sibling's or child's spouse.

Past performance of persons affiliated with a school

A school is not financially responsible if a person who exercises substantial control over the school (or any members of the person's family alone or together) owes a liability for an SFA Program violation, or has ever exercised substantial control over another school (or a third-party servicer) that owes a liability for an SFA 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 person 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 its employees. This is no longer a federal requirement for schools that participate in the SFA Programs. However, some schools are still required to maintain fidelity bond coverage because state laws require it. Even if it is not required to do so, a school may choose to maintain fidelity bond coverage to protect itself when losses occur resulting from a lack of integrity, honesty, or fidelity 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 could call into question the school's financial responsibility. (For more information, see Chapter 10.)

FINANCIAL STATEMENTS

All financial statements are received by the Document Receipt and Control Center (DRCC). The DRCC calculates a school's composite score. The DRCC also assesses a school's economic viability and any unusual accounting treatments or policies. If a school's composite score is below 1.5, the DRCC will forward the school's financial statement to the Department's case management team. The DRCC will also forward a school's financial statement upon the request of a case team.

If by U.S. Postal Service

U.S. Department of Education, IPOS
P.O. Box 44805
L'Enfant Plaza Station
Washington, DC 20026-4085

If by commercial overnight or courier delivery

U.S. Department of Education, IPOS
7th and D Streets, SW
GSA Building, Room 3514
Washington, DC 20026-4085

FOREIGN SCHOOLS

A foreign school must meet the financial responsibility standards for domestic schools unless the school received less than \$500,000 (in United States dollars) in SFA Program funds during its most recently completed fiscal year. A school that received less than \$500,000 will have its financial responsibility determined through the Department's examination of the school's audited financial statement for the school's most recently completed fiscal year, and may have its audited financial statement prepared according to the standards of the school's home country. A foreign school that received \$500,000 or more in SFA Program funds during its most recently completed fiscal year must have its audited financial statement translated and presented for analysis under U.S. Generally Accepted Accounting Principles (GAAP) and Generally Accepted Government Auditing Standards (GAGAS).

