Audits, Standards, Limitations, & Cohort Default Rates

CHAPTER 4

This chapter discusses the requirement for annual compliance and financial statement audits. It also discusses the financial standards and limitations that pertain to schools' FSA eligibility as well as the annual calculation of school cohort default rates.

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 its compliance with the laws and regulations for the FSA programs that it participates in (a compliance audit) and an audit of its financial statements. 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. For information about compliance and accounting issues, a school can contact the school participation division (SPD) for its region.

The audits must be conducted in accordance with the Generally Accepted Accounting Principles (GAAP) and the Generally Accepted Government Auditing Standards (GAGAS). They must be prepared by an independent public accountant or a government auditor, except that a government auditor must meet the government auditing standards qualification and independence standard, including standards related to organizational independence. The compliance audit and financial statement audit may be performed by different auditors, but they must be submitted as one package via the Department's eZ-Audit website.

The source of guidance for the audits depends on the entity:

- For-profit schools and third-party servicers must have their audits conducted under the Office of Inspector General's (OIG) *Guide For Audits of Proprietary Schools and For Compliance Attestation Engagements of Third-Party Servicers Administering Title IV Programs* (Audit Guide).
- Foreign schools use the *Guide for Financial Statement Audits and Compliance Attestation Engagements of Foreign Schools* (Foreign School Audit Guide), newly updated for 2020.
- Public and private nonprofit schools follow the regulations that implement the Single Audit Act: 2 CFR Part 200 Subpart F—Audit Requirements. These regulations require schools to have

Audit requirements & waiver
HEA Sec. 487(c)
20 USC 1094
34 CFR 668.23(a)(1) to (5)
Waiver 34 CFR 668.27

Audit requirements for federal awards
2 CFR Part 200 Subpart F
Requirements 200.501
Relation to other audit requirements 200.503

audits conducted in accord with *2 CFR Part 200, Appendix XI Compliance Supplement* (Compliance Supplement), published annually by the Office of Management and Budget (OMB). For many schools, this is a combined audit of all the federal programs they participate in. Note that 2 CFR Part 200 Subpart F does allow an FSA compliance audit under the criteria of the Audit Guide in certain circumstances.

The Audit Guide and Foreign School Audit Guide are available on the webpage for audits of proprietary and foreign schools and third-party servicers. The Compliance Supplement is available on the webpage for single audits.

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.

As noted, 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.

AUDIT GUIDELINES AND WAIVERS

Audited financial statements

A school's financial statement must cover its most recently completed fiscal year and be prepared on an accrual basis according to GAAP. It must be audited by an independent auditor according to GAGAS and the instructions in the guide appropriate for the school, as noted.

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 done by an independent auditor according to GAGAS and the guidance contained in the Compliance Supplement or the appropriate audit guide. The auditor may also find it useful to consult the accounting and record keeping guidance in the FSA Handbook and the *G5 Users Guide* (which is available on the G5 website).

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 guidelines

As mentioned earlier, public and private nonprofit schools are required to have audits performed under the guidelines of the Single Audit Act and the Compliance Supplement for 2 CFR 200 Subpart F, which has distinct auditing and submission requirements. For instance, the deadline for these audits being submitted to the Department through the eZ-Audit website is no later than nine months after the end of the school's fiscal year. In addition, a copy of the audit as well as form SF-SAC must be submitted online to the Federal Audit Clearinghouse.

Because the Higher Education Act and its implementing regulations require annual submissions of schools' compliance and financial statement audits, a submission prepared under the Single Audit Act provisions that does not include a compliance audit does not meet the HEA audit requirement. Read the announcement from August 5, 2016.

However, if the school's auditor identifies its student financial assistance cluster, which includes the Title IV programs, as a low-risk major program (Type A) (as defined in 2 CFR 200.518) in a given year, that cluster does not need to be included in the compliance audit, and the school is not required to notify its school participation division of the low-risk assessment. See the announcements of March 29, 2018, and November 5, 2019, for more information.

As explained in the section on waivers, a nonprofit school that expends less than $750,000 of federal funds during a fiscal year is exempt from submitting an annual audit. However, it is still required to submit a financial statement to the Department within six 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, it must submit those statements to the Department.

The Compliance Supplement 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. But because the FSA program regulations require a financial statement audit, a school may not submit a program-specific audit to satisfy the Department's audit requirement.

Criteria for granting a waiver
34 CFR 668.27(c)
Waiver for a public or nonprofit institution
2 CFR 200.501(d)

Waivers of the 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 in each of the two most recently completed award years to be eligible for the waiver, and the school must also meet the other criteria in 34 CFR 668.27. A public or private nonprofit institution that expends less than $750,000 in federal funds in a fiscal year is exempt from filing compliance audits after the school gains initial eligibility. 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 financial statement audit until six months after

- the end of the third fiscal year after the one the school last submitted compliance and financial statement audits for, or
- the end of the second fiscal year after the one the school last submitted compliance and financial statement audits for 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.

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, at the end of that time the school's next compliance audit must cover its administration of the FSA programs for each fiscal year in the waiver period. The financial statement audit must cover the last year of the waiver period. The auditor for a proprietary school must audit, and attest to, the school's annual 90/10 determination for each year in the waiver period, in accord with 34 CFR 668.23(d)(4).

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.

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 the school's total financial health. So that the Department can make this determination, a school must include in

Qualifying for and Effects of Waivers

Qualifying for a 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.

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 resulting 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.

Effects of waivers—examples

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) and it submits a compliance audit for its fiscal year that ends on June 30, 2018, and then receives a waiver, its next compliance audit is due six months after the end of its 2020–2021 fiscal year. When it submits that audit, it must cover the 2018–2019, 2019–2020, and 2020–2021 fiscal years.

Example 2: If a school's fiscal year ends June 30, 2018, and the school receives a waiver on May 1, 2018, that includes the 2018–2019, 2019–2020, and 2020–2021 fiscal years, the next compliance audit is due six months after the end of the school's 2020–2021 fiscal year.

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 No. 57*. The description must include all related parties and a level of detail that would enable the Department to easily identify them. 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 entity and the school, financial or otherwise, regardless of when it occurred.

TIMING OF AUDIT SUBMISSIONS

Simultaneous FSA audit submissions

Both the compliance audit and the financial statement audit must be performed on a fiscal-year basis and submitted at the same time. 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.

In 2020–2021 for schools using a calendar year as their fiscal year, the most recently completed one is the fiscal year that ends on December 31, 2020. For schools using the award year as their fiscal year, the most recently completed one will be the fiscal year that ends on June 30, 2021.

Submission dates for FSA audits

A school's or servicer's compliance and financial statement audits performed under the Audit Guide must be submitted to the Department within six months after the end of the school's or servicer's fiscal year. The following chart lists audit due dates and the period the audit must cover. (The chart provides information for the most common institutional fiscal-year-end dates.)

Audits performed under the Compliance Supplement must be submitted within nine months after the end of the school's fiscal year.

Audit submission due dates

School's fiscal year end date	*Both audits due*	*Period audited (financial and compliance)*
September 30, 2020	March 31, 2021	October 1, 2019, through September 30, 2020
December 31, 2020	June 30, 2021	January 1, 2020, through December 31, 2020
March 31, 2021	September 30, 2021	April 1, 2020, through March 31, 2021
June 30, 2021	December 31, 2021	July 1, 2020, through June 30, 2021

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.

Small Business Administration National 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 will evaluate annually the enforcement activities of each agency and rate its 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) or email ombudsman@sba.gov.

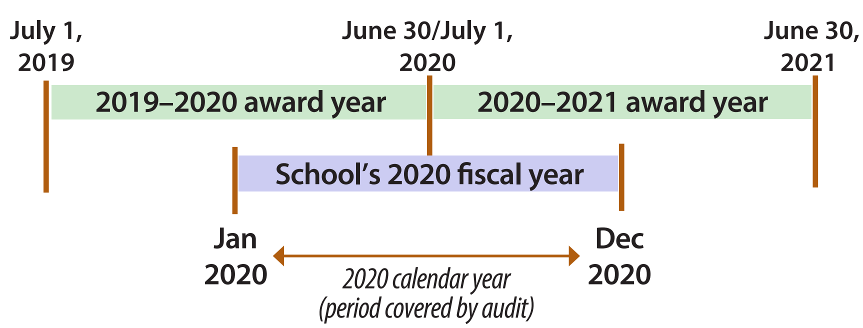
90/10 REVENUE TEST

90/10 Rule
HEA section 487
34 CFR 668.14(b)(16)
34 CFR 668.28

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 on the following pages each fiscal year.

A proprietary school must report as a footnote to its audited financial statements the percentage of its revenues derived from the FSA programs for the fiscal year covered by the audit. 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.

Example: school's fiscal year ≠ FSA award 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 or PPA.)
- 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.

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

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

Schools can ask questions of their SPD; phone numbers and the general e-mail (CaseTeams@ed.gov) are on the SPD webpage.

If the school loses eligibility, it must immediately stop awarding FSA funds and follow the closeout procedures described in *Chapter 8*.

A school that converts from a proprietary to a nonprofit or public status for Title IV purposes must continue to report its compliance with the 90/10 revenue test for at least one complete fiscal year after the change in status has been approved by the Department. For example, a change in status is approved with an effective date of 10/31/18 for a school whose fiscal year ends on December 31. The school would be required to report the 90/10 revenue attestation for the complete 2018 fiscal year, and it would also be required to report its 90/10 compliance for its first complete fiscal year (2019) of participation as a nonprofit school. If the school failed the test for that first year under the new status, it would need to report an additional year. If there were other problems with the attestation, the school could also be required to report one more year.

Guidance on footnote disclosures can be found in the 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 the 90/10 rule to the PPA from the definition of a proprietary institution of higher education.

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 these loans, see 34 CFR 668.28(b) and 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.

(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;

Counting Revenues for the 90/10 Rule, continued

(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 are not an inflow of cash to the school. Institutional scholarships are not revenues generated by the school unless they are donated by an unrelated or outside 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 a school's 90/10 calculation for the fiscal year in which the revenues were received, provided that the school'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.

AUDIT AND 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 initially determine whether the audits are materially complete and done according to applicable accounting standards. Based on the financial data, we will also make a preliminary determination 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 your school satisfies the financial ratio requirements discussed later in this chapter. Later we will review submissions to determine whether your school must provide additional information or we 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, it must repay any improperly spent funds within 45 days.

Access to records

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.

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.

Third-party servicer audits
34 CFR 668.23(a)(3), (c), and (d)(4)

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 Generally Accepted Accounting Principles (GAAP) and audited by an independent auditor in accordance with Generally Accepted Government Auditing Standards (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.

The Department is aware that some third-party servicers have told schools not to report them as servicers, creating confusion about who should be reported. Also, some servicers have not filed annual compliance audits because they incorrectly determined that they don't meet the regulatory definition of a third-party servicer or because of the omission of specific audit procedures in the OIG Audit Guide for some services or functions performed on behalf of colleges. See DCL GEN-15-01 for clarification of the third-party servicer requirements in the regulations.

Using eZ-Audit to submit financial statements and audits

The eZ-Audit website provides a paperless, single point of submission for compliance and financial statement audits. It checks automatically for errors as data is entered and before submission, and it gives instant acknowledgment of receipt of the submission.

Schools must submit their compliance audits, audited financial statements, and letters confirming their status as public schools through eZ-Audit. This requirement applies to any compliance audits or financial statements schools must submit to begin or continue participating in the FSA programs under 34 CFR 600.20(a) or (b), any financial statements required due to a change in ownership resulting in a change of control as provided under 34 CFR 600.20(g), 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).

Beginning in August 2020, all entities that are required to submit compliance audits and financial statements to FSA will use eZ-Audit's web-based system to submit those documents; hard copies will no longer be sent to FSA. This is a change for foreign schools, third-party servicers, Federal Family Education Loan (FFEL) Program lenders, FFEL lender servicers, guaranty agencies (GAs), and GA servicers. Because these entities will be new to eZ-Audit, they must first register before gaining access to the system. See the July 17, 2020, announcement for more information.

To access the eZ-Audit website, one must be a registered user and sign and retain the eZ-Audit rules of behavior. Each entity must select an eZ-Audit institution administrator who will be responsible for managing its access to the eZ-Audit website. This administrator will receive a user name and password and will be responsible for granting access to additional users. Registration instructions and the rules of behavior are available at https://ezaudit.ed.gov.

Users go to the appropriate page on the audit website and

1. enter general information about the school's compliance audit and financial statement,
2. enter specific financial data directly from the audited financial statement, and
3. attach authentic electronic copies of the audit originals prepared and signed by the independent auditor.

Audit copies must be in a non-editable, portable document format (PDF) created using Adobe Acrobat version 5.0 or higher.

For help, users can email fsaezaudit@ed.gov or call the eZ-Audit help desk at 1-877-263-0780.

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.)

Financial responsibility
HEA Sec. 498(c)
34 CFR 668, Subpart L, Appendices A and B

FINANCIAL RESPONSIBILITY

To participate in the FSA programs, schools must demonstrate they are financially responsible. They provide the Department with the information necessary to evaluate their financial responsibility via the audited financial statement explained earlier.

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. They can also review the attachment to an April 2020 announcement, which is a list of Q's and A's pertaining to financial responsibility and eZ-Audit reporting requirements.

The Department determines whether a school is financially responsible based on its ability to provide the services described in its official publications and statements, to meet all of its financial obligations, and to provide the administrative resources necessary to comply with title IV, HEA program requirements.

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 and public schools
34 CFR 668.171(g)

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 one-time 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 and private nonprofit schools

General standards
34 CFR 668.171(b)

General standards of financial responsibility

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

- the school has a composite score of at least 1.5, as explained later in this chapter;
- the school has sufficient cash reserves to make required returns of unearned Title IV funds, as provided under the refund reserve standards explained later in this chapter;
- the school or persons affiliated with it are not subject to a condition of past performance, as explained later in this chapter;
- the school is able to meet all of its financial obligations and provide the administrative resources necessary to comply with Title IV program requirements. A school is not deemed able to meet its financial or administrative obligations if it
  - ◊ fails to make refunds under its refund policy or return Title IV funds it is responsible for under the R2T4 rules,
  - ◊ fails to make repayments to the Department for any debt or liability arising from its participation in the Title IV programs, or
  - ◊ is subject to a *mandatory triggering event* or to a *discretionary triggering event* that the Department determines is likely to have a material adverse effect on their financial condition. See "Mandatory and discretionary triggers" later in this chapter.

Audit opinions and disclosures
34 CFR 668.171(h)

Even if a school satisfies all of these general standards of financial responsibility, the Department does not consider it to be financially responsible if, in its audited financial statements, the opinion expressed by the auditor was an adverse, qualified, or disclaimed opinion or if there is a disclosure in the notes to the financial statements that there is substantial doubt about the school's ability to continue as a going concern as required by accounting standards. This holds unless the Department determines that a qualified or disclaimed opinion does not have a significant bearing on the school's financial condition or that the substantial doubt about its ability to continue as a going concern has been alleviated.

A school that fails to meet any of the above criteria can still qualify as a financially responsible institution. It can submit an irrevocable letter of credit that is acceptable and payable to the Department for an amount that is not less than 50% of the Title IV funds the school received during its most recently completed fiscal year. A school can also continue to participate if it submits a 10% letter of credit and agrees to be provisionally certified. See, respectively, "Financial protection alternative for participating schools" and "Provisional certification alternative" later in the chapter for an explanation of these options.

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

Triggering events
34 CFR 668.171(c) and (d)

Mandatory and discretionary triggers

There are key differences between the two types of triggering events. Generally, the mandatory triggers reflect actions or events whose consequences are realized immediately and which evidence or cause the Department to presume an adverse material effect on the school's financial condition. The burden falls on the school to demonstrate otherwise when it notifies the Department that the event has occurred. On the other hand, discretionary triggers generally reflect actions or events whose consequences are less immediate and less certain. For a discretionary trigger, the Department will need to show that the event is likely to have a material adverse effect on the school's financial condition or jeopardize its ability to continue as a going concern. The Department will consider in the review any additional information provided by the school when it reports that event.

In general schools must report any triggering event to the Department within 10 days after the event occurs [see §668.171(f) for details about what and when to report]. However, in the case of the 90/10 trigger, schools have until 45 days after the end of their fiscal year to notify the Department.

The **mandatory triggers** are:

- The school incurs a liability from a settlement or a final judgment or determination arising from an administrative or judicial action or proceeding by a federal (which can include the Department) or state entity that results in the school's recalculated composite score dropping below 1.0 for the most recently completed fiscal year.
- For a proprietary school whose composite score is less than 1.5, there is a withdrawal of owner's equity by any means (e.g., a distribution of dividends or return of capital)—unless the withdrawal is a transfer to an entity in the affiliated group on whose basis the school's composite score was calculated—that results in the school's recalculated composite score dropping below 1.0 for the most recently completed fiscal year.
- For a publicly traded school any of the three following events occurs: (1) the U.S. Securities and Exchange Commission (SEC) issues an order suspending or revoking the registration of the school's securities or suspends trading of its securities on any national securities exchange; (2) the national securities exchange on which the school's securities are traded notifies the school that it is not in compliance with the exchange's listing requirements and, as a result, its securities are delisted, either voluntarily or involuntarily; or (3) the SEC is not in timely receipt of a required report and did not issue an extension to file the report.
- If, for the most recently completed fiscal year, the school is subject to two or more discretionary triggering events described below. When that happens, they become mandatory triggering events, unless an event is resolved before another one occurs.

The **discretionary triggers** are:

- The school's accrediting agency issued an order, such as a show cause order or similar action, that if not satisfied could result in the withdrawal or suspension of the school's accreditation for failing to meet the agency's standards.
- The school violated a provision in a security or loan agreement with a creditor causing it to require or impose on the school an increase in collateral or interest rates or payments; a change in contractual obligations; or other sanctions, penalties, or fees.
- The school's state licensing or authorizing agency notified the school that it has violated a requirement and that the agency intends to terminate its licensure or authorization if it does not take the steps necessary to comply with the requirement.
- For its most recently completed fiscal year, a proprietary school did not receive at least 10 percent of its revenue from sources other than Title IV HEA program funds (the 90/10 rule).
- As calculated by the Department, the school has high annual dropout rates. (The methodology for this is yet to be determined.)
- The school's two most recent official cohort default rates are 30 percent or greater, unless the school files an appeal for one or both of those fiscal years that either remains pending, results in reducing below 30 percent the default rate for one or both of those years, or precludes the rate from one or both years from resulting in a loss of eligibility.

Recalculating the composite score

Recalculating a composite score
34 CFR 668.171(e)

As explained under the first two mandatory triggers, the Department recalculates a school's most recent composite score in those instances. It does so by recognizing the actual amount of the liability, or cumulative liabilities, the school incurs (the first trigger) as an expense; it also treats the actual withdrawal, or cumulative withdrawals, of owner's equity (the second trigger) as a reduction in equity. Moreover, the Department accounts for these expenses or withdrawals by

- For liabilities incurred by a proprietary institution: (1) for the primary reserve ratio, increasing expenses and decreasing adjusted equity by that amount; (2) for the equity ratio, decreasing modified equity by that amount; and (3) for the net income ratio, decreasing income before taxes by that amount;
- For liabilities incurred by a non-profit institution: (1) for the primary reserve ratio, increasing expenses and decreasing expendable net assets by that amount; (2) for the equity ratio, decreasing modified net assets by that amount; and (3) for the net income ratio, decreasing change in net assets without donor restrictions by that amount; and

- For the amount of owner's equity withdrawn from a proprietary institution: (1) for the primary reserve ratio, decreasing adjusted equity by that amount; and (2) for the equity ratio, decreasing modified equity by that amount.

Relief for triggering events
34 CFR 668.171(f)(3)

Alleviating a triggering event

When a school first notifies the Department of a triggering event or when it responds to a preliminary determination by the Department that it is not financially responsible because of a triggering event, the school can try to relieve the effect of the event by, as appropriate,

- Demonstrating that the reported withdrawal of owner's equity was used exclusively to meet tax liabilities of the school or its owners for income derived from the school;
- Showing that the creditor waived a violation of a loan agreement. However, if the creditor imposes additional constraints or requirements as a condition of waiving the violation or imposes penalties or requirements, the school must describe those actions and demonstrate that complying with them will not adversely affect the school's ability to meet its financial obligations;
- Showing that the triggering event has been resolved or demonstrating that the school has insurance that will cover all or part of a liability arising under the relevant mandatory trigger; or
- Providing information about the circumstances that precipitated the trigger that demonstrates that the event has not or will not have a material adverse effect on the school.

The Department will consider the information the school provides when deciding whether to issue a final determination that the school is not financially responsible.

Financial Ratios
34 CFR 668.172

FINANCIAL RATIOS AND COMPOSITE SCORES

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 and gives an equitable measure of the financial health of schools of different sizes.

The composite score methodology considers proprietary schools (see Appendix A in Part 668 Subpart L) and private nonprofit schools (see Appendix B) separately because there are accounting and operational differences between these sectors of postsecondary schools. However, the basic steps used to arrive at the composite score are the same and are described later in this section. Appendices A and B have complete information on the calculation of the composite score.

Calculating a composite score

The first step in calculating a 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 its capital resources and ability to borrow. The net income ratio represents a measure of its 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 "Excluded items" later.)

As a result of the 2019 final regulations, long-term debt may be included in the primary reserve ratio only if it is associated with the school's property, plant, and equipment (PP&E) or construction in progress (CIP). The school's financial statements must disclose that its long-term debt exceeds 12 months and is associated with capitalized assets. However, to account for long-term debts that existed prior to the implementation of these regulations, their treatment in the composite score calculation will be grandfathered under the old rules. Schools should review the regulations and consult with their accountants when considering the treatment of long-term debt. The new rules are reflected in appendices A and B to Subpart L.

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 on a scale from negative 1.0 to positive 3.0 as shown in the following diagram. This scale reflects the probability a school will be able to continue operations and meet its obligations to students and the Department.

Accounting for operating leases
34 CFR 668.172(d)

Accounting for operating leases

The Department accounts for operating leases by

- Applying the Financial Accounting Standards Board's Accounting Standards Update (ASU) 2016-02, Leases (Topic 842) to all leases the school has entered into on or after December 15, 2018 (post-implementation operating/financing leases), as specified in the supplemental schedule (see Section 2 of both Appendix A and Appendix B to Subpart L);
- Treating leases the school entered into prior to December 15, 2018 (pre-implementation operating/financing leases), as they would have been treated prior to the requirements of ASU 2016-02, as long as the school provides information about those leases on the supplemental schedule and a note in, or on the face of, its audited financial statements; and
- Accounting for any adjustments, such as options the school exercises to extend the life of a pre-implementation operating/finance lease, as post-implementation operating/finance leases.

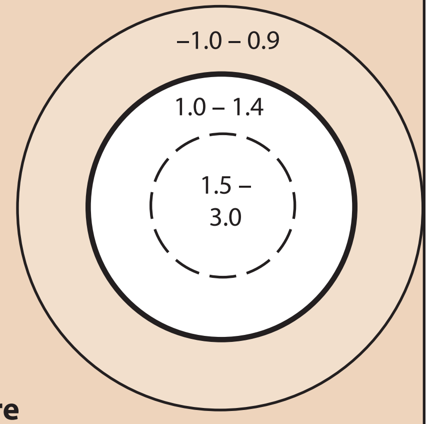
Financial ratio excluded items
34 CFR 668.172(c)

Excluded items

In calculating a school's ratios, the Department

- 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;
- May include or exclude the effects of questionable accounting treatments, such as excessive capitalization of marketing costs;
- Excludes all unsecured or uncollateralized related-party receivables;
- Excludes all intangible assets defined as intangible in accordance with generally accepted accounting principles; and
- Excludes from the ratio calculations federal funds provided to a school by the Department under programs authorized by the HEA only if
    - ◊ in the notes to the school's audited financial statement, or as a separate attestation, the auditor discloses by name and Catalog of Federal Domestic Assistance (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
    - ◊ the school's composite score, as determined by the Department, is less than 1.5 before the reported expenses arising from those HEA funds are excluded from the ratio calculations.

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 0.9 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

Primary Reserve Ratio $= \dfrac{\text{Adjusted equity}}{\text{Total expenses}} = \dfrac{\$760{,}000}{\$9{,}500{,}000} = 0.0800$

Equity Ratio $= \dfrac{\text{Modified equity}}{\text{Modified assets}} = \dfrac{\$810{,}000}{\$2{,}440{,}000} = 0.3320$

Net Income Ratio $= \dfrac{\text{Income before taxes}}{\text{Total revenues}} = \dfrac{\$510{,}000}{\$10{,}010{,}000} = 0.0509$

Calculation of Strength Factor Score

Primary Reserve Strength Factor Score = 20 x Primary Reserve Ratio
20 X 0.0800 = 1.6000
Equity Strength Factor Score = 6 x Equity Ratio
6 X 0.3320 = 1.9920
Net Income Strength Factor Score = 1 + (33.3 x Net Income Ratio)
1 + (33.3 x 0.0509) = 2.6950

Calculation of Weighted Score

Primary Reserve Weighted Score = 30% x Primary Reserve Strength Factor Score
0.30 X 1.6000 = 0.4800
Equity Weighted Score = 40% x Equity Strength Factor Score
0.40 X 1.9920 = 0.7968
Net Income Weighted Score = 30% x Net Income Strength Factor Score
0.30 X 2.698 = 0.8094

Composite Score

Sum of All Weighted Scores 0.4800 + 0.7968 + 0.8094 = 2.0862 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.

Refund reserve standards
34 CFR 668.173

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).

When a state submits a tuition recovery fund for approval, 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.

Timely return of funds
34 CFR 668.173(b)

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. The regulations specify that a school has returned funds when it has

- deposited or transferred the funds into the bank account it maintains for federal funds (see the section below) no later than 45 days after the date it determines 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.

After a school has returned unearned funds to its federal account, provided those funds were originally received from the Department 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 through the same program and in the same award year.

Maintaining and accounting for funds
34 CFR 668.163

Deposit to operating or separate account

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.

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 time frame permitted in the regulations.

See the sections on accounting for funds and depository accounts in *Chapter 1* of *Volume 4*.

Compliance thresholds

Compliance thresholds
34 CFR 668.173(c)

The Department provides 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 a 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.

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

If the preliminary report finds that the school did not return unearned funds in a timely manner for 10% or fewer of the sampled students, it 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.

ALTERNATIVES TO THE GENERAL FINANCIAL STANDARDS

Alternative standards and requirements
34 CFR 668.175

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 it 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 does not qualify for an alternative, the Department may initiate a limitation, suspension, or termination action against the school (see *Chapter 8* for more on corrective actions and sanctions).

Provisional certification
34 CFR 668.13

Letter of credit alternative for new schools

Letter of credit for new schools
34 CFR 668.175(b)

A new school (one seeking to participate in the FSA programs for the first time) that is not financially responsible solely because it has a composite score of less than 1.5 may still demonstrate financial responsibility. It can do so by submitting an irrevocable letter of credit, acceptable and payable to the Department, or another surety, which the Department specifies in the Federal Register, equal to at least 50% of the FSA program funds that the Department determines the school will receive during its initial year of participation.

Financial protection alternative for participating schools

Financial protection alternative for participating schools
34 CFR 668.175(c)

A participating proprietary or private nonprofit school that fails to meet one or more of the general standards or has an adverse audit opinion may still demonstrate financial responsibility. It can do so by submitting an irrevocable letter of credit, acceptable and payable to the Department (or providing other financial protection described below), that the Department determines is equal to at least 50% of the FSA program funds the school received during its most recently completed fiscal year. Note that this requirement does not apply to public schools.

Financial protection

Financial protection
34 CFR 668.175(h)

According to procedures established by the Department or as part of an agreement with a school, the Department may use the funds from that financial protection to satisfy the debts, liabilities, or reimbursable costs, including costs associated with allowed teach-outs, owed to the Department that are not otherwise paid directly by the school.

In lieu of a school submitting a letter of credit, the Department may permit the school to

- provide the amount required in the form of some other financial protection the Department specifies in the *Federal Register*;
- provide cash for the amount required; or
- enter into an arrangement under which the Department offsets the amount of Title IV funds that a school has earned in a manner that ensures that, no later than the end of a six- to twelve-month period selected by the Department, the amount offset

equals the amount of financial protection the school must provide. The Department provides the school any funds not used for the purposes described in the first paragraph of this section during the period covered by the agreement, or provides the school any remaining funds if it subsequently submits other financial protection for the amount originally required.

Zone alternative
34 CFR 668.175(d)

Zone alternative

A participating school that 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

1. must request and receive funds under the cash monitoring or reimbursement payment methods, as specified by the Department (see *Volume 4, Chapter 2*);
2. 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);
3. may be required to provide information about its current operations and future plans;
4. must require as part of its compliance audit that its auditor express an opinion on the school's compliance with the requirements of the zone alternative, including the school's administration of the payment method under which it received and disbursed FSA program funds; and
5. must provide timely information—within ten days of occurrence—on any of the following oversight and financial events:

    ◊ Any event that causes the school, or related entity as defined in Accounting Standards Codification (ASC) 850, to realize any liability that was noted as a contingent liability in the school's or related entity's most recent audited financial statement; or

◊ Any losses that are unusual in nature or infrequently occur, or both, as defined in accordance with Accounting Standards Update (ASU) No. 2015-01 and ASC 225.

Provisional certification alternative

Provisional certification alternative
34 CFR 668.175(f)

The Department may permit a participating proprietary or private nonprofit school to participate under provisional certification for up to three years if the school is not financially responsible because it does not satisfy one or more of the general standards, has an unacceptable audit opinion, is subject to a mandatory trigger or to a discretionary trigger that the Department determines will have an adverse material effect, has a recalculated composite score of less than 1.0, or has a past performance problem that has been resolved. 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.

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

- submit a letter of credit payable and acceptable to the Department (or provide other protection described under "Financial protection" earlier) for not less than 10%, as determined by the Department, of the FSA program funds the school received during its most recent fiscal year; this requirement does not apply to a public school backed by the full faith and credit of the state;
- demonstrate that it has met all of its financial obligations and was current on debt payments for its two most recent fiscal years; and
- comply with provisions 1–5 that are listed under the zone alternative.

The Department maintains the full amount of financial protection from the school until it first determines that the school has either: a composite score of 1.0 or greater based on a review of the audited financial statements for the fiscal year in which all liabilities from any triggering event required the financial protection, or a recalculated composite score of 1.0 or greater and any triggering event has ended.

If the school is still not financially responsible at the end of the provisionally certified period, the Department may again permit it to participate under a provisional certification but may require

- the school, or one or more persons or entities that exercise substantial control over it, to provide financial guarantees for an amount the Department determines is enough to satisfy any potential liabilities that may arise from the school's participation in the Title IV programs;
- one or more of the persons or entities that exercise substantial control over the school to be jointly or severally liable for any li-

abilities that may arise from the school's participation in the Title IV programs; and

- the school to provide, or continue to provide, the financial protection resulting from a mandatory or discretionary trigger until the school meets the composite score requirement above.

Provisional certification for schools 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.

Past performance
34 CFR 668.174

PAST PERFORMANCE

In addition to meeting the standards of financial responsibility and fulfilling all its financial obligations, a school must demonstrate that it properly administers the FSA programs. 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

Past performance of a school
34 CFR 668.174(a)

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

Past performance of persons
34 CFR 668.174(b)

A school is not deemed financially responsible if anyone who exercises substantial control over the school—or if any members of her family—either owes a liability for an FSA program violation or exercises or has ever exercised substantial control over another school or a third-party servicer that owes such a liability. This is true 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 or demonstrates to the Department

- that an acceptable portion of the liability was repaid according to the regulations;
- that the liability is currently being repaid under a written agreement with the Department; or
- (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.

Past performance and exercise of substantial control
34 CFR 668.174(b)(1) and (c)

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

Conditions of institutional ineligibility
34 CFR 600.7

STUDENT AND COURSE LIMITATIONS

An otherwise eligible school becomes ineligible if it 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 notification must occur by July 31 after the end of an award year. The Department will advise the school of its options, including whether it might be eligible for a waiver. (Waivers are available for the limitations for correspondence students, incarcerated students, and students without a high school diploma or equivalent.) 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.

In addition to the limitations explained 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 follow the steps for a school that has lost its FSA participation. See *Chapter 8*.

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 school's regular students (those students not receiving job training through contracts with federal, state, or local government agencies) do not have a high school diploma or its equivalent. If granted, the waiver may be extended 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 each year an audit is conducted.

Incarcerated student limitation and waiver

Incarcerated student limitation
34 CFR 600.7(a)(1)(iii) and 600.7(c)

A school is ineligible if, in its latest complete award year, more than 25% of its regular students are incarcerated. For information on the eligibility of incarcerated students for FSA, see *Volume 1, Chapter 1*.

A public or private nonprofit school can ask the Department to waive this limitation. If granted, the waiver is effective as long as the school continues to meet the waiver requirements each award year. For a school offering only 2-year or 4-year programs that lead to associate or bachelor's degrees, the waiver applies to all programs at the school. But if the school offers other types of programs, the waiver would apply to any of the school's 2-year associate degree programs or 4-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 public or private nonprofit school may request the waiver using the E-App (**https://eligcert.ed.gov**) by answering the questions in Section G and explaining in question 69.

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).

Correspondence study limitation
Sec. 102(a)(3)(A) and (B) of the HEA
34 CFR 600.7(a)(1)(i) and (ii) and
600.7(b)(2)(i) and (ii)

Carl D. Perkins Career and Technical Education Act of 2006
20 U.S.C. 2301

Notifying ED when limit is exceeded
34 CFR 600.7(h)

Correspondence course and student limitations

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) or
- 50% or more of the school's regular 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.

Note that the correspondence course and student limitations do not apply to a school that exclusively or mainly provides vocational adult education or job training as defined under Sec. 3(3)(C) of the Carl D. Perkins Career and Technical Education Act of 2006.

Also 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. For more on correspondence study vis-à-vis program eligibility, student eligibility, and cost of attendance, see *Chapter 2*; *Volume 1, Chapter 1*; and *Volume 3, Chapter 2* respectively.

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

A school is the sum only of its eligible programs

Some schools offer programs that are eligible for FSA as well as those that are not. For FSA program purposes, we consider an eligible institution to be 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.

COHORT DEFAULT RATES

Default rates
HEA Sec. 435(m)
20 U.S.C. 1082, 1085, 1094, 1099c
34 CFR Part 668 Subpart N
DCL GEN-14-03

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 guaranty agencies and federal 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 NSLDS Professional Access website. Schools must be enrolled in the eCDR process for electronic delivery of the rates. They can sign up for that process by completing the enrollment form on the SAIG Enrollment website.

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 the school and entered repayment in a single fiscal year—the federal fiscal year, October 1–September 30.

For instance, a school's FY2017 CDR is based on the cohort of students who received FFEL or Direct Loans at the school and entered repayment on those loans between October 1, 2016, and September 30, 2017. This number becomes the denominator (the lower part of the fraction) in the CDR calculation.

$$\frac{\text{X}}{\textbf{Total borrowers who entered repayment during FY2017}}$$

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

$$\frac{\textbf{Total borrowers who entered repayment in FY2017 and defaulted in FY2017, 2018, and 2019}}{\textbf{Total borrowers who entered repayment during FY2017}}$$

Because it takes three years to track the outcomes, the initial FY2017 CDR for a school is not released until three years later, at the beginning of 2020. This is one of the reasons that schools should closely monitor student borrowing and implement effective default prevention procedures as soon as possible. The steps taken to help students this year may reduce the number of defaults in the CDR three years from now.

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

Calculating the Percentages

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 regular students enrolled in an institution's Title IV-eligible programs 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:

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

Consequences of high cohort default rates

High default rates
34 CFR 668.206

Schools face sanctions under the following conditions:

- For a cohort default rate of greater than 40 percent for any year, schools lose eligibility to participate in the Direct Loan Program.
- For a default rate of 30 percent or more for any year, schools must create a default prevention taskforce that will develop and implement a plan to address the high default rate. That plan must be submitted to the Department for review.
- For a default rate of 30 percent or more for a second consecutive year, schools must submit to the Department a revised default prevention plan and may be placed on provisional certification.
- For a cohort default rate of 30 percent or more for three consecutive years, schools lose eligibility to participate in both the Direct Loan Program and the Federal Pell Grant Program.

Moreover, a school is not considered to be administratively capable when

- the CDR for Federal Stafford/SLS loans or Direct Subsidized/Unsubsidized Loans made to students for attendance at the school equals or exceeds 30% for two of the three most recent fiscal years or
- the CDR for Perkins loans made to students for attendance at the school exceeds 15%. See *Volume 6* for other rules and associated penalties related specifically to high Perkins default rates.

Default rates and administrative capability
34 CFR 668.16(m)

When a high default rate demonstrates a lack of administrative capability, a school may become ineligible to participate in the Direct Loan, Pell Grant, or Perkins programs, or the Department may choose to provisionally certify such a school. For detailed information on default rates, including challenges and appeals, refer to the *Cohort Default Rate Guide* on the IFAP website.

Default prevention and management plan

As mentioned, if a 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 the default rate to exceed the threshold,
- establishes measurable objectives and the steps the school will take to improve the default rate, and
- specifies the actions the school will take to improve student loan repayment, including counseling students on repayment options.

A school must submit its default prevention plan to its school participation division for review. If the cohort default rate is equal to or greater than 30% for two consecutive fiscal years, the default prevention plan must be revised and submitted again for review.

Default prevention and 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 implement a default management plan.

A school applying to participate is 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.

Default rate and contact information on the Web

The Operations Performance Division in Federal Student Aid responds to questions about cohort default rates and reviews cohort default rate challenges, adjustments, and appeals. It also provides technical assistance and outreach to schools to assist them in lowering their default rates. More information, including searchable default rates for all schools participating in the FSA programs, is available on the default management website. Schools can also call the hotline at (202) 377-4259 or email fsa.schools.default.management@ed.gov.