Report of the NAICU Financial Responsibility Task Force

November 2012

National Association of
Independent Colleges and
Universities

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Dear Reader:

The process of ensuring students that the college they attend has the financial resources necessary to protect against sudden closure, and that the institution has the funds required to deliver a quality education, is challenging but essential work.

This nation's diverse array of higher education institutions is unparalleled in the world, and stands as one of the crowning achievements of our pluralistic society. They range from major research universities to small beauty schools; from public colleges to mission-specific institutions; from family businesses to publicly traded companies; and of course, to the incredible diversity within just the nonprofit private sector. Their financing structures also are varied, reflecting their primary purposes as charitable, profit-making, or public. As a result, this mix of missions across higher education means that institutions operate under differing accounting rules for different sources of revenue, in meeting their different financial goals. Trying to address this broad variance through a simple and comparable accountability formula is not easy.

In accommodating these differences, the federal system of assessing financial stability has worked fairly well for the past 20 years, since first being mandated under the 1992 Higher Education Act. In general, the system has given students and taxpayers a reasonable measure of fiscal integrity at institutions, built upon professionally accepted accounting principles.

The economic downturn that began in late 2007, however, revealed the limitations of the existing system. In the years that followed, an unusually large number of otherwise stable nonprofit institutions failed the ratios test that is an integral part of the federal Financial Responsibility Standards (FRS). The findings often came as a surprise to institutions' chief financial officers and outside accountants whose own professional assessments didn't indicate institutions at risk of closure, nor ones where the quality of students' education was suffering. The fallout from these "false negatives" created further problems for the institutions. In addition to alarmist media reports, many had to expend precious resources on such measures as costly letters of credit as part of an alternate FRS test, when those funds would have been better used in helping families meet the financial pressures of the economic downturn.

After consultation with the U.S. Department of Education, the National Association of Independent Colleges and Universities (NAICU) established a task force to examine the disparity between the federal formula results and professional assessments of institutional stability. The following report summarizes the task force's findings. We offer these recommendations to both the Department of Education and Congress as possible avenues for improving the federal system so that it better aligns with current professional accounting practices.

We owe a special debt of gratitude to the National Association of College and University and Business Officers (NACUBO), the Council of Independent Colleges (CIC), and the several financial experts who lent their extensive professional knowledge to this complex challenge.

The public and the federal government alike must be assured that the institutions accepting federal student aid are fiscally prudent and financially stable. Our hope is that these findings lead to an improved federal system for such an assessment -- a system that ultimately will serve our nation's students and taxpayers more efficiently and effectively.

Sincerely,

Kent Chabotar
Chair, NAICU Task Force on Financial Responsibility Standards
President, Guilford College
Member, NAICU Board of Directors

EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

In November 2010, following the unexpected failure of more than 100 nonprofit colleges on the financial ratios test -- an integral part of federal Financial Responsibility Standards -- the National Association of Independent Colleges and Universities (NAICU) Board of Directors established a task force to review the process. The task force met regularly throughout 2011 and 2012. Ultimately, it found the Department of Education's process in need of improvement, and this report recommends several actions to overcome the issues it identified.

The recent economic downturn exposed significant shortcomings with the current administration of the financial responsibility ratios test. The negative consequences for institutions with failing composite scores were further exacerbated by the publication of the list of failed institutions. Many colleges with failing composite scores have had to obtain letters of credit, which can be costly, draining precious financial resources from their budgets. For institutions that are not at risk of precipitous closure, these resources could have been better directed to helping the institutions and their students cope with the economic recession.

Nonprofit colleges and accounting experts for nonprofit institutions expressed widespread concern about the accuracy and appropriateness of the financial responsibility test. However, the Department indicated that it lacked the resources to systematically study the problem. This led NAICU to establish a task force of higher education and accounting experts for nonprofit institutions to examine the current system and suggest possible areas of reform.

Background

Section 498(c) of the Higher Education Act (HEA) requires the Secretary of Education to determine the financial responsibility of post-secondary institutions, and was enacted following the unannounced closures of several for-profit institutions in the late 1980s that left students in the lurch. The primary purpose of the law is to guard against the precipitous, or sudden, closure of post-secondary institutions. The statute provides several ways for institutions to demonstrate financial responsibility.

The current regulations implementing this section of the law were developed in 1996-97 with broad higher-education community collaboration. Since that time, accounting standards have evolved, and it is no longer clear that the current regulatory process is meeting its intended goal.

The Department's regulations provide the details of the primary method for determining a nonprofit institution's financial responsibility, which is to assess the value of three financial ratios, then combine them into a composite score that must reach a prescribed threshold. The ratios were designed to take into account the total financial resources of the institution.

Financial responsibility is determined using accounting principles appropriate for each of the various sectors of higher education -- public, for-profit, and nonprofit. The ratios are calculated from information in the audited financial statements and the eZ-Audits institutions provide to the Department at the end of an institution's fiscal year. Institutions with composite scores below the threshold may alternatively establish their financial responsibility through methods such as obtaining a letter of credit.

SUMMARY OF RECOMMENDATIONS AND FINDINGS

Recommendation 1: Ensure that the Department conforms to the HEA statute, follows the current financial responsibility regulations, and uses standard accounting definitions when determining nonprofit colleges' financial responsibility.

Related findings:

A. *The Department does not consistently follow its own regulations for financial responsibility. If the Department had complied with its own rules, many of the institutions that recently failed the federal test would have achieved scores that were different than those published, and in certain cases, colleges that received failing scores would have received passing scores.*

B. *Despite the fact that the law indicates that "generally accepted auditing standards" will be followed, the Department has not updated its definitions to reflect changes to accounting standards as articulated by the Financial Accounting Standards Board (FASB). There are seven major items that are utilized in the composite score calculations that the Department often misinterprets, with a significant negative effect on institutions' composite scores.*

C. *Contrary to current regulations, the Department has erroneously been classifying losses reported in the income statement as expenses. This includes losses on all investments (endowment and other investments), as well as other types of losses. This was a significant factor in the failing composite financial responsibility scores received by many nonprofit institutions in 2010.*

Recommendation 2: If the Department continues to treat endowment and other losses as expenses for nonprofit institutions, then the primary reserve ratio should be expanded to include all net assets (unrestricted, temporarily restricted and permanently restricted) of the institution in the formula for expendable net assets.

Related findings: *Such an adjustment would make the nonprofit financial responsibility formula comparable to that used by for-profit institutions. Including endowment net assets when evaluating the current fiscal health of a nonprofit institution is as justifiable as including owner equity for proprietary schools.*

Recommendation 3: Retain the alternative methods for demonstrating financial responsibility as currently defined in statute and the regulations, even if other changes are made in the calculation of financial responsibility composite score.

Related finding: *When a college receives a failing composite score, the law provides alternative paths for affirming its financial responsibility, such as (1) submitting an irrevocable letter of credit to the Department; or (2) agreeing that the college's operations, including its administration of the federal student aid programs, be monitored more closely by the Department -- which includes either receiving funds under the cash monitoring or reimbursement payment methods and additional reporting to the Department. These options are important for institutions, while also protecting the federal fiscal interest in student aid funds.*

Recommendation 4: The Department of Education should establish a uniform appeals process as part of the financial responsibility procedures. This would assure institutions of the opportunity to correct or update financial information before their composite financial responsibility scores are made final and released to the public.

> ***Related finding:*** *There are significant differences in how the Department of Education's regional offices calculate financial responsibility scores, and in the offices' willingness to address individual colleges' concerns about the accuracy of their institutional scores.*

Recommendation 5: The Secretary of Education should fully implement the legal requirement, under Section 498(c)(3)(C) of the Higher Education Act, to step back and examine the "total financial circumstances" of institutions that fail the ratios test before assessing penalties.

> ***Related finding:*** *A number of private higher education institutions that have received failing financial responsibility composite scores were financially viable, and continued to provide quality education for years afterward. The Secretary should take into account the "total financial circumstances" of an institution before labeling it as failing, and causing the institution to incur unnecessary expenses or suffer adverse public relations .*

Recommendation 6: Establish an advisory panel of objective nonprofit accounting experts to provide technical guidance to the Department.

> ***Related findings:*** *There is pervasive misinterpretation by the Department of its own regulations on financial responsibility and of generally accepted accounting principles (GAAP). Updating and training staff, especially non-accountants, could enhance and improve the financial responsibility analysis of nonprofit colleges without added expense for the Department.*

How the Financial Responsibility Test Works

- The financial health of institutions is assessed based on three ratios: primary reserve, equity, and net income. An institution's raw scores are converted to strength factors, weighted, and combined into a composite score.

- Composite scores range from -1.0 to +3.0. Institutions with scores of 1.5 or above "pass." The Department considers them financially responsible without the need for further oversight. Institutions below 1.5 "fail."

- The Department does not permit those below 1.0 to continue participation in Title IV programs without providing additional surety, e.g., a letter of credit that guarantees at least 50% of its Title IV funding or 10% combined with additional constraints imposed under provisional certification.

- Institutions with composite scores between 1.0 and 1.4 are allowed to participate in Title IV under a "zone alternative," under which they are subject to special disbursement requirements and enhanced monitoring.

- Public institutions are not evaluated using the ratio methodology. A public institution is considered financially responsible if it submits a letter from an official of a state or other government entity confirming that the institution is public.

Even if a college or university passes the test with a composite score of 1.5 or above, the Department has other standards that institutions must meet. They must have sufficient cash reserves to make refunds and repayments of Title IV funds. They must be current in paying debt service. They must not have a statement by the auditor in its audited financial statements expressing doubt about the survival of the institution as a "going concern" or, unless the Department grants an exception, anything other than an unqualified opinion that the audited statement is presented in accordance with generally accepted accounting principles.

THE NAICU TASK FORCE ON FINANCIAL RESPONSIBILITY

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The NAICU financial responsibility task force met regularly throughout 2011 and 2012. It analyzed the current law and regulations, compared the Department determinations of financial responsibility with the results obtained when using current accounting standards consistently, and developed a set of recommendations based on the findings of its work.

Structure and Process

In November 2010, the NAICU Board of Directors established a task force to review the federal government's system for determining the financial responsibility of nonprofit colleges. Financial responsibility is an institutional requirement for participation in the Title IV federal student aid programs. The task force was composed of NAICU members and staff, independent accountants, campus financial experts, as well as staff from the National Association of College and University Business Officers (NACUBO) and the Council of Independent Colleges (CIC). The chair of the task force was Kent Chabotar, president of Guilford College, who is an expert in the field and a member of the NAICU Board. Additional experts were consulted for assistance, especially in modeling exercises.

Following initial discussions of the various issues in the financial responsibility formula and Department procedures, the chair formed three working groups to assemble and analyze information on identified problem areas and to test alternatives to existing formulas. The three working groups and their purposes were:

1) **Inconsistent Application of the Regulations**, to review the varying accounting and oversight practices among the regional offices of the Department of Education.

2) **Accounting Inaccuracies and Misinterpretations,** to review the Department's use of standard nonprofit accounting rules and definitions.

3) **Financial Analysis**, to model and test alternative financial responsibility formulas less susceptible to external economic factors that might yield more accurate results.

In addition, *ad hoc* subgroups were established as specific questions arose. For example, one subgroup researched the correlation between failing scores and precipitous school closure, and another looked at the possibility of adding an appeals process for reviewing financial responsibility scores before they are published. The working and *ad hoc* subgroup areas of investigation and their results are provided in more detail in the About Research section *(see page 21)*.

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RECOMMENDATIONS AND FINDINGS

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The task force considered a number of issues, including the lack of consistency in the Department's application of regulations, changes to financial accounting standards, the lack of a uniform appeals process, and equitability in the methodology for calculating scores. The task force also reviewed a variety of formulas for assessing financial responsibility that would reliably provide more accurate scores for nonprofit institutions than the current methodology *(see box, page 8)*. The task force understood that any formula for financial responsibility scores must provide a true and reliable picture of nonprofit colleges' financial strength -- to protect students, federal student aid funds, and institutions from inaccurate or unfair assessments that could waste their resources or threaten their existence.

The following six recommendations emerged from that effort.

S P O T L I G H T

A **200-year-old private liberal arts college**, which has received passing financial responsibility composite scores since the current regulation took effect in the late 1990s, was surprised to learn it had received a failing score from the Department of Education in FY 2011. It was even more surprised when the Department retroactively changed the college's FY 2010 score from passing score to failing. Its independent auditor's calculation, using the Department's own formula, showed the college receiving passing scores in both cases.

The problem resulted from the Department analyst's interpretation of the "spendability" of the college's temporarily restricted net assets. In 2009, FASB had made a change in its guidance on classification of spendable endowment funds. While the classification of such funds had been changed (from "unrestricted net assets" to "temporarily restricted net assets"), the assets still could be spent by the college upon the decision of the board - that did not change.

The definition of "expendable net assets" in the Department's regulation explicitly includes temporarily restricted net assets. With an endowment of $77.9 million in FY 2011, and an operating budget of only $25 million, the college was not in financial trouble, but had to spend $56,000 on a letter of credit.

Recommendation # 1:

Ensure that the Department conforms to the HEA statute, follows the current financial responsibility regulations, and uses standard accounting definitions when determining nonprofit colleges' financial responsibility.

Issue A: The Department does not consistently follow its own regulations for financial responsibility.

Discussion: Through its analysis, the task force has found that if the Department had complied with its own rules, many institutions' scores would have been different than their published score, and certain institutions that recently failed the federal test would have passed.

The financial responsibility regulations establish a process for determining the financial stability of an institution that was intentionally designed to be simple and efficient. The standardized method calls for institutions to provide financial data to the Department through submission of audited financial statements and completion of an online eZ-Audit template that pulls out relevant data elements.

This process was intended to enable the Department to use the information, as audited by independent accountants in accordance with professional standards, to calculate the various financial responsibility ratios. Unfortunately, the Department has not always followed this process. At times, its analysts have adjusted or defined certain key financial elements from the financial statements in ways that are at variance with generally accepted accounting standards.

In general, these adjustments fail to reflect the differences between nonprofit and for-profit accounting procedures. Although the regulations contain clear and distinct definitions and financial responsibility formulas for the two sectors, Department analysts sometimes inappropriately apply for-profit definitions in the calculations of the primary reserve and net income ratios for nonprofits.

There are four areas where this problem is most often manifested.

1. Endowments (which don't exist at for-profits) and related gains/losses on endowment investments

2. Plant infrastructure and related long-term liabilities

3. Pledges (contributions receivable) to the institution

4. Retirement plans (pensions and health care)

Impact: The kinds of accounting errors in the calculations that were noted by the task force have a significant negative effect on the composite scores of many institutions. Correcting these financial adjustments and misclassifications can raise a failing score to a passing one, or vice versa. The task force identified seven components that the Department often misapplied in its calculations of financial responsibility scores. *(See matrix, page 18.)* Each of these has been shown to be problematic.

Issue B: The Department's accounting practices do not consistently conform to GAAP.

Discussion: According to their professional code, certified public accountants must adhere to a set of specific principles when reviewing and providing opinions on financial statements or other financial data for federal financial reporting. GAAP is compiled and kept current by FASB. The task force has found that changes in GAAP since 1997 are being overlooked or misinterpreted by the Department, to the detriment of nonprofit institutions. *(See matrix, page 18.)*

Impact: The Department's nonconformity with GAAP has resulted in some nonprofit schools receiving failing, or inaccurate, scores when they otherwise would have passed.

***Issue C: Of particular note, in determining the financial responsibility of nonprofit institutions, the Department often treats decreases in endowment investments, as well as other losses, as expenses*.**

Discussion: The Department's failure to follow GAAP when it classifies endowment losses as expenses (money spent for the day-to-day operations of the institution) has perhaps the most significant negative impact on an institution's financial responsibility score of any of the misapplied accounting elements in the financial responsibility formula.

The Department's treatment is not in conformity with accounting practices for nonprofit institutions, nor is it in conformity with the Department's own nonprofit financial responsibility formula and regulations. Under the definitions in the financial responsibility regulations, and also under GAAP, such losses are not considered expenses.

It is incorrect to consider endowment losses in the denominator of the primary reserve ratio. Just as with a decrease in the value of an individual's retirement funds, the loss is not immediate and doesn't affect the ability to cover current expenses.

Impact: The task force identified more than a half-dozen areas in which the Department is not in conformity with GAAP standards. *(See matrix, page 18.)* This particular misapplication warrants added attention since it is the largest identifiable contributor to failing composite scores -- particularly in the period following the market decline that began in 2008.

GAAP

The term generally accepted accounting principles (GAAP) has a specific meaning for accountants and auditors. The American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct prohibits members from expressing an opinion or stating affirmatively that financial statements or other financial data "present fairly…in conformity with generally accepted accounting principles," if such information contains any material departures from GAAP.

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. The Financial Accounting Foundation is the independent, private sector organization that is responsible for the oversight, administration, and finances of the FASB, the GASB, and their advisory councils FASAC and GASAC. The Foundation's primary duties include protecting the independence and integrity of the standards-setting process and appointing members of the FASB, GASB, FASAC, and GASAC. In 1973, the Foundation established the Financial Accounting Standards Board (FASB) to establish and improve standards of financial accounting and reporting for nongovernmental entities. Consistent with that mission, the FASB maintains the FASB Accounting Standards CodificationTM (Accounting Standards Codification) which represents the source of authoritative standards of accounting and reporting, other than those issued by the SEC, recognized by the FASB to be applied by nongovernmental entities.

(From FASB website)

The American Institute of Certified Public Accountants, founded in 1887, is the world's largest association representing the accounting profession, with nearly 386,000 members in 128 countries. AICPA members represent many areas of practice, including business and industry, public practice, government, and education, and offers specialty credentials for CPAs who concentrate on personal financial planning; fraud and forensics; business valuation; and information technology. Through a joint venture with the Chartered Institute of Management Accountants (CIMA), it has established Chartered Global Management Accountant (CGMA) designation to elevate management accounting globally. The AICPA sets ethical standards for the profession and U.S. auditing standards for audits of private companies, non-profit organizations and federal, state and local governments. It develops and grades the Uniform CPA Examination.

(From AICPA website)

Misused Ratio Components that Negatively Impact Nonprofit Institutions

Except where noted, each of the items below is:

- Highly significant to the overall score
- Not compliant with current regulations
- Not compliant with GAAP
- Not applied consistently

Ratio Component	Location in the Audited Financial Statements	Department of Education Interpretation	Result
1. Total expenses	Nonprofit institutions, defined as "total unrestricted expenses" taken directly from the statement of activities.	Uses the definition for proprietary institutions (which includes expenses and losses).	Decreases the primary reserve ratio
2. Long-term debt	From the statement of financial position (balance sheet) or found in the notes to the financial statements.	Excludes long-term lines of credit, working capital loans or certain other debt (which mature in more than one year), and other facilities-related liabilities identified by FASB since 1997.	Decreases the primary reserve ratio
3. Total unrestricted revenue	Taken directly from the statement of activities, and includes net assets released from restrictions during the fiscal year.	Includes gains with revenue. Also occasionally nets losses (investments, swaps, actuarial losses) against revenue.	Increases or decreases the primary reserve ratio
4. Post-employment and retirement benefits	From the statement of financial position (balance sheet) or found in the notes to the financial statements. In some cases, it may need to be obtained from the institution.	Excludes the liability for pension benefits.	Decreases the primary reserve ratio
5. Unsecured related party receivables (pledges receivable for nonprofit entities)	In the notes to the financial statements. In some cases, it may need to be obtained from the institution.	Does not allow the pledge receivable exclusion granted to nonprofits in the preamble to the 11/25/97 rule. Thus, considers pledges from board members to be unsecured related party receivables.	Decreases the equity ratio and the primary reserve ratio *Note: This is not a GAAP issue.*
6. Annuities, term endowments, and life income funds included in temporarily restricted net assets	In the notes to the financial statements. In some cases, it may need to be obtained from the institution.	Assumes all endowment net assets included in temporarily restricted net assets are term endowments (including accumulated gains on endowments).	Decreases the primary reserve ratio
7. Net property, plant and equipment (PPE)	From the statement of financial position (balance sheet). Construction in progress (CIP) is found on the statement of position or in the notes to the financial statements or obtained from the institution.	Subtracts CIP from total net PPE. Does not consider CIP to be part of PPE until the asset is placed in service.	Increases the primary reserve ratio

Recommendation # 2:

If the Department continues to treat endowment and other losses as expenses for nonprofit institutions, then the primary reserve ratio should be expanded to include all net assets (unrestricted, temporarily restricted and permanently restricted) of the institution in the formula for expendable net assets.

Issue: The Department often classifies decreases in college endowments (realized and unrealized losses) as a component of total expenses -- in lay terms, an institution's "operating expenses" -- in the calculation of the nonprofit primary reserve ratio.

Discussion: If Recommendation #1 is not adopted, and the Department persists in counting an institution's endowment declines as a component of total expenses, then the institution should also be able to count the *value* of its endowment (across all net asset classes) in the formula for calculating the primary reserve ratio.

If the Department includes endowment losses in the denominator of the primary reserve ratio, then logically all equity (net assets) generating such losses -- including the donor-restricted endowment -- should be included in the numerator of the ratio. Supporting the rationale for such consideration of endowments are recent changes to the state laws governing endowment funds. Under the Uniform Prudent Management of Institutional Funds Act, which has been adopted by a majority of the states *(see box, right)*, institutions are allowed more flexibility over spending related to the donor-restricted endowment funds, since the requirement to maintain historic gift value was removed from the law.

Such an adjustment to the ratios would make the nonprofit financial responsibility formula comparable to that used by for-profit institutions, which allows adjusted equity to be used to calculate the primary reserve ratio. For nonprofit institutions, endowment principal would be included because it is as justifiable a source to cover the expenses and obligations of nonprofit institutions, as owner net assets (adjusted equity) are for proprietary schools.

Impact: The incorrect interpretation of nonprofit colleges' income statements, particularly adjusting "total expenses" to include endowment losses, creates an imbalance between the numerator and the denominator of the primary reserve ratio, and produces false-negative results for nonprofit colleges, with a significant negative impact on the financial responsibility scores of many institutions. As such, it has resulted in an increased number of institutions failing the financial responsibility test after the precipitous market decline of 2008.

Uniform Prudent Management of Institutional Funds Act

Over the past decade, all states except Pennsylvania and Puerto Rico have adopted a major update of the Uniform Management of Institutional Funds Act (UMIFA) of 1972, which governs the expenditure and investment practices of charitable institutions. The recent amendments are referred to as UPMIFA (Uniform Prudent Management of Institutional Funds Act) and bring the law governing the financing of nonprofit institutions more in line with modern investment and expenditure practices.

Perhaps the most significant change, for purposes of the Department of Education's financial responsibility standards, is that UPMIFA provides institutions of higher education greater flexibility in using restricted endowment funds, thus making it even more compelling for the Department to consider the value of these funds when considering the overall financial viability of a nonprofit institution.

Recommendation # 3:

Retain the alternative methods for demonstrating financial responsibility as currently defined in statute and the regulations, even if other changes are made in the calculation of financial responsibility composite score.

Issue: Alternative routes to demonstrate financial responsibility have provided important flexibility and stability for schools.

Discussion: When an institution receives a failing financial responsibility score, or otherwise fails to meet a standard of financial responsibility, the law provides alternative paths which, depending upon the circumstances, enable an institution to affirm financial responsibility. One "fall back" alternative allows a failing institution to submit an irrevocable letter of credit to the Department. The letter of credit must be for an amount not less than one-half of the Title IV funds received by the institution in the most recently completed fiscal year, in order for the institution to be considered financially responsible. (A letter of credit functions like an insurance policy with a bank, covering the federal funds if the school actually closes.)

Institutions with scores under the 1.5 threshold for passage but equal to at least 1.0 -- or "in the zone" -- may be considered financially responsible for the next three years if they continue to maintain a score within that range (1.0-1.4), and if the college meets specific monitoring requirements. They must agree to operate under the Department's cash monitoring or reimbursement payment methods, and to provide timely information on such items as adverse actions by the institution's accrediting agency, certain negative financial events, and extraordinary losses.

Alternatively, some institutions deemed not financially responsible may be provisionally certified by providing a letter of credit that protects from 10 to 100 percent of the Title IV funds received by the institution in the most recently completed fiscal year. They also must comply with the provisions of financial responsibility for schools that are "in the zone," as noted above. With additional monitoring, the Department can track financial changes more closely.

Impact: These alternatives represent an important set of options for institutions in responding to their specific situations -- enabling the institutions to improve their financial condition over time, while protecting the federal fiscal interest in their student aid funds.

In the recent economic downturn, many colleges used one of the alternative methods to establish their financial responsibility. The Department has made it clear that such an institution is financially responsible *(see box, below).* However, institutions that met the alternative requirements for demonstrating financial responsibility were still listed as having failing scores.

"The composite financial score is one measure of a school's financial responsibility and is meant to gauge a school's ability to meet its financial obligations. The composite financial score is not a reflection of the quality of education at a given school. If a school does not achieve a passing financial composite score, it does not mean that the school is in danger of closing.

"The Department may still consider the school to be in compliance with the standards of financial responsibility if the school agrees to additional reporting, financial aid monitoring or administrative oversight requirements and/or agrees to take steps that mitigate the risk that the school may not be able to meet its financial obligations, such as posting a letter of credit to insure the financial obligations of the school.... "

The U.S. Department of Education to the
Hartford Courant*, August 23, 2010*

Recommendation # 4:

The Department of Education should establish a uniform appeals process as part of the financial responsibility procedures. This would assure institutions of the opportunity to correct or update financial information before their composite financial responsibility scores are made final and released to the public.

Issue: Colleges have no consistent way to appeal inaccurate assessments, to update financial information, or to find out how the Department arrived at its score for the institution.

Discussion: There is no official appeal process for contesting or correcting a financial responsibility score, nor do institutions consistently receive a draft score for review before the Department finalizes and releases the score. In other areas of regulation, procedures exist for such review. For example, several months prior to publication of the final cohort default rate (CDR) for Stafford Student Loans, institutions receive a draft CDR rate.

Task force members reviewed the Department's calculations of numerous nonprofit colleges' composite scores and compared them to the institutions' financial statements and notes. This examination revealed errors, inappropriate inclusion of financial data in the ratios, and improper application of for-profit accounting standards in the calculation of the nonprofit institutions' scores. In addition, the independent review revealed significant inconsistencies in the interpretation of the regulations by Department analysts, and in the willingness of the regional offices and Department headquarters to address inaccuracies in calculating the scores.

The task force working group on this issue developed a list of accounting items in which the differing interpretations of the regions and headquarters could affect an institution's financial responsibility score *(see box, page 24)*. These inconsistencies included, among other items, the way in which losses on investments and interest rate swaps, maturities of long-term debt, retirement obligations, and lines of credit were factored into the financial responsibility calculations.

Department analysts often appear to be seeking information that is not part of the official financial statements or the eZ-Audit submission template. Department reviewers have sometimes extrapolated beyond the financial statement elements. Unfortunately, these interpretations frequently are not consistent with definitions either in the regulations or generally accepted accounting principles (GAAP). *(See matrix, page 18.)*

Impact: Incorrect or inconsistent interpretation of an institution's financial data can determine if a college passes or fails the financial responsibility test. The Department may, on a case-by-case basis, informally review and -- depending on the evidence -- make changes to a financial responsibility score; however, the practice varies from region to region. Publishing inaccurate scores can unfairly harm the financial viability of an institution, and syphon off resources from students.

An alternative to establishing an appeals process through administrative action would be to amend the statute to provide for such a process. Since financial responsibility scores are lagging indicators of an institution's financial situation, it might also be possible to design a method for updating scores when an institution's financial situation improves prior to publication of the next year's financial responsibility score. The task force has developed suggested language for the structure of an appeals process *(see box, next page).*

Appeals Process
Possible Statutory Language

The Secretary shall:

(1) Provide annually to each institution subject to the requirements of 498(c) a notification of its preliminary score under such section;

(2) Provide to each institution, a description of the method used and complete copies of all the calculations performed to determine the institution's score, provided such institution makes the request within 45 days of receiving the notice under (1);

(3) Within 45 days of each institution receiving information under (2),

   (A) Permit the institution to correct or cure an administrative, accounting, or recordkeeping error if the error is not part of a pattern of error and there is no evidence of fraud or misconduct related to the error;

   (B) Make corrections to the Secretary's calculation if the institution demonstrates that the Secretary has made errors in its determination of the initial score or has used non-standard accounting practices in reaching its determination;

   (C) Take into consideration any subsequent change in the institution's overall fiscal health, the consideration of which, would raise the institution's score;

(4) Maintain and preserve at all times the confidentiality of any review until such score is determined to be final; and

(5) Ensure that such scores are developed in accordance with accepted principles of accounting.

Recommendation # 5 :

The Secretary of Education should fully implement the legal requirement, under Section 498(c)(3)(C) of the Higher Education Act (HEA), to step back and examine the "total financial circumstances" of institutions that fail the ratios test before assessing penalties.

Issue: Private institutions that do not pass the ratios test have no alternative to prove their financial responsibility that does not impose significant costs.

Discussion: HEA Section 498(c)(3) *(see Appendix C),* provides four alternatives to the ratios test for institutions to establish financial responsibility. Three of these alternatives have been fully implemented, but not the fourth, which would offer a less expensive alternative than third-party guarantees or reimbursement for institutions to establish that they are financially sound. This option, establishing that the institution will not precipitously close and can meet all its financial obligations, should be fully implemented.

> Section 498 (c) (3) *The Secretary shall determine an institution to be financially responsible, notwithstanding the institution's failure to meet the* (ratios test) *. . . if – (C) such institution established to the satisfaction of the Secretary, with the support of a financial statement audited by an independent certified public accountant in accordance with general accepted auditing standards, that the institution has sufficient resources to ensure against the precipitous closure of the institution, including the ability to meet all of its financial obligations (including refunds of institutional charges and repayments to the Secretary for liabilities and debts incurred in programs administered by the Secretary) . . .*

Impact: This would provide consistency across higher education sectors under the law, in that the alternative for public institutions (of having the institution's liabilities backed by the full faith and credit of the state) has been implemented.

S P O T L I G H T

A **liberal arts college** had received top financial responsibility composite scores prior to the current recession. Like most colleges, it saw a decline in its endowment as a result of the market collapse. Despite the loss, the college calculated that it would still receive a passing score of 1.5. It didn't.

The Department gave the college a failing score, resulting in the college's having to buy an expensive letter of credit. The failing score resulted from several improper calculations of the college's composite score by the Department.

- It doubled the negative impact of the endowment loss by adding it to "total expenses" in the denominator of the primary reserve ratio, while at the same time legitimately decreasing the "expendable net assets" by the loss amount in the numerator.

- It further skewed the primary reserve ratio negatively by improperly classifying a long-term debt as a current debt, because the loans in question were "due on demand" if the college violated provisions of the loan agreement. GAAP classifies this type of debt as "noncurrent debt."

- It also excluded a very sizeable pledge from a trustee, saying it was a "related party receivable," from the college's "expendable net assets" -- the numerator in the primary reserve ratio, despite the fact that a trustee is not a related party according to accounting rules.

Recommendation # 6:

Establish an advisory panel of objective nonprofit accounting experts to provide technical guidance to the Department.

Issue: The Department would benefit from a panel of independent, nonprofit accounting experts.

Discussion: There has been longstanding disagreement between the Department's staff and outside accounting experts on the interpretation of the financial responsibility regulations and provisions in GAAP, as well as Departmental disagreement with institutions over the interpretation of their financial statements. Given this divergence of views, it might be useful to convene a body of accounting experts for nonprofit institutions to provide technical guidance to the Department in this area.

Such a group could review the Department's current methodology, make recommendations, and assist with incorporating future changes in accounting standards. The Department uses advisors in various aspects of its work – from technical review panels, to negotiated rule-making. Such outside assistance might be useful in this area as well.

Impact: An outside body of experts could assist the Department, at little or no cost to the Administration, in updating its practices and improving staff training. Consistent practices and a consistent knowledge base across the regions would prevent the regional inconsistencies noted in the table below.

Regionally Inconsistent Accounting Elements

1. Construction-in-progress (CIP) excluded from property, plant, and equipment (PPE).
2. Losses on investments and interest rate swaps included in expenses.
3. Institutional share of the Perkins loan fund moved from unrestricted net assets (URNA). to permanently restricted net assets (PRNA) by the Department of Education.
4. Contributions receivable from board members were considered unsecured related party receivables.
5. Lines of credit – due before the end of the next fiscal year (short-term) were classified as long-term debt and lines of credit due in the next fiscal year (i.e., long term) were excluded from long-term credit.
6. Current maturities of long-term debt were not included as part of long-term debt.
7. Defined benefit plan liabilities were excluded from "post-retirement benefit plan liabilities" for calculating expendable net assets.
8. All amounts shown in brackets on the Statement of Activities (SOA) were included in expenses.

ABOUT THE RESEARCH

ABOUT THE RESEARCH

The task force explored a number of ways to address the concerns of financially viable institutions that received failing composite scores. These included testing alternative methods that might be used to categorize or calculate financial responsibility for nonprofits, an analysis of the accuracy of the current composite score methodology in predicting precipitous closure of institutions, and a review of specific problems associated with the application of the current formula to individual institutions. In conducting their work, task force subcommittees analyzed various institutions' financial information. Examinations consisted of reviewing audited financial statements, eZ audit submissions, appeals to the Department of Education on financial responsibility composite scores, and applying alternative ratio formulas. The information was derived from a variety of sources including data voluntarily submitted to task force members and their organizations, and various publicly available databases. Additional background on the task force's data sources and research efforts are described below.

Data Sources

1. Institutions with Low Composite Scores

NAICU invited member institutions that had financial responsibility scores below 1.5, as reported on the Department's FY 2010 published list, to submit their audited financial statements and eZ-Audit information for fiscal years 2009 through 2011 to NACUBO, in order for the task force to perform a more detailed analysis of their scores. In all, 21 private, nonprofit institutions accepted the invitation and submitted their financial information.

2. The Council of Independent Colleges Database

The Council of Independent Colleges (CIC) has a database of FY 2007, 2008, and 2009 financial data on more than 800 nonprofit baccalaureate and master's level private colleges. The data were collected from two public sources: the U.S. Department of Education's Integrated Postsecondary Data System (IPEDS) and Internal Revenue Service Form 990s obtained from GuideStar. CIC member institutions verify their data prior to CIC analysis. CIC produces an annual financial benchmarking report for its members that utilizes KPMG's Composite Financial Index (CFI) as a tool that compares multiple indicators to help its member institutions assess their fiscal strength. As part of the benchmarking tool, CIC encourages institutions to compare their CFI scores with the Financial Responsibility Test scores, noting the similarities and differences between the two scores. The CIC data set enabled the task force to model alternative formulas to the existing financial responsibility method.

3. Private Higher Education Database

One task force member who works with over 150 higher education institutions located throughout the country had access to a financial database for those institutions. The database included the calculation of the three financial ratios from which the composite scores are derived, for institutions ranging from ones that would be considered financially stable, to ones that were dealing with significant financial challenges. As a result, it provided a good mix of nonprofit institutions. The task force believed this database was a particularly useful tool in analyzing the Department's inconsistent application of the formulas, and its inconsistent adherence to generally accepted accounting standards.

Assessments Conducted

1. Examination of 21 Institutions with Low Composite Scores

The financial information for each of the 21 participating NAICU institutions was entered into a database, and was assessed using three steps:

A. Determined if the Department (a) followed the formulas as defined in the financial responsibility regulations; (b) consistently applied the formulas defined in the financial responsibility regulations; and (c) followed generally accepted accounting principles (GAAP) and accounting definitions when performing the calculations.

   This was done to illustrate how the inconsistent application of the formulas, combined with inaccurate interpretations of nonprofit accounting definitions, caused variances in the composite score results published by the Department.

B. Re-calculated the composite score by following the formula for nonprofit colleges as defined in the Department's regulations.

   This was done to illustrate how the use of the correct nonprofit accounting definitions in the regulation affects the composite score. In our study of more than 20 nonprofit institutions, none of them passed the test even when correct definitions were used. Upon further analysis, this made sense because, for the most part, these institutions did not have large endowments so were not impacted as much by investment market losses as wealthier institutions.

   Beyond this test sample, the task force more importantly looked at certain otherwise financially healthy institutions that nonetheless had fallen below a score of 1.5, based on the Department's calculation, but passed when the definitions for nonprofit institutions in the regulation were correctly applied. In addition, based on a review of the available databases, the task force found that, if the formulas were applied correctly and in accordance with GAAP, a number of institutions' actual composite scores would differ from their published scores.

C. Applied an alternative formula for the primary reserve ratio that parallels the method used with for-profit institutions.

   This was suggested by the task force to level the playing field among nonprofit and for-profit institutions. The Department has consistently applied a portion of the for-profit definition to nonprofits when calculating the primary reserve ratio. In the for-profit sector, the primary reserve ratio includes expenses and losses in the denominator and total equity in the numerator. For nonprofits, the primary reserve ratio is defined as expendable net assets divided by total expenses. The Department has often incorrectly added losses to expenses in the denominator. However, the Department does not use a calculation comparable to total equity (i.e., total net assets including permanently restricted net assets) in the numerator for nonprofit institutions. This creates a significant difference between the nonprofit sector and the for-profit sector in the calculation of the scores. By allowing all net asset classes to be considered expendable, the for-profit definition is applied in both the numerator and denominator of the primary reserve ratio; this compensates for the Department's insistence that losses must be added to expenses.

Another rationale for including all net asset classes, or total equity, as expendable in the nonprofit formula is that a new model law – Uniform Prudent Management of Institutional Funds Act, or UPMIFA *(see box on page 19)* enacted in 49 states allows greater flexibility in the use of donor restricted endowments. While each state has passed its own version of the law, under the general law an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment was established. UPMIFA eliminates former requirements of a permanent corpus that cannot, under any circumstances, be spent.

2. Consideration of Alternative Methods for Calculating Scores

The task force considered whether certain adjustments to the existing method of calculating the financial responsibility scores would produce results less likely to yield false-negatives. The tests were run on the CIC database using FY 2007 and 2008 financial data from 752 nonprofit baccalaureate and master's level private colleges. The task force considered three scenarios: (1) revising the capping convention to eliminate the ceilings and floors of the ratio strength factors; (2) using a three-year rolling average of the Net Income Ratio; and (3) combining alternative calculations (1) and (2) in the same scenario.

A. Capping the Financial Responsibility Scale

The task force considered whether adjusting or removing the floor and ceiling caps on the ratio strength factors and composite scores *(the range of -1.0 to +3.0 described in the box on page 8)* would provide a more accurate picture of an institution's financial situation relative to other institutions.

The subgroup tested several scenarios in which the caps were removed. The results of the modeling showed that institutions' scores with the caps removed were similar to the existing methodology used by the Department. The FY 2007 pass rate using the current method was 94.1 percent. It increased .6 to 94.7 % when the caps were used. The FY 2008 pass rates were 91.2 percent versus 91.0 percent.

After some analysis, the task force determined that the existing capped scale was preferable to eliminating the score's floor and/or ceiling. While the Department's capped score had some problems -- e.g., it produced some counter-intuitive results such as Harvard having a worse score than a regional beauty school -- the capped score did avoid the even more misleading problem of creating the appearance of a precise rating scale.

B. Use a Three-year Average

Using the same CIC database, the task force tested the use of a three-year rolling average of the Net Income Ratio (the ratio used in the financial responsibility composite score that is most subject to changes in external market conditions, such as endowment loses or gains). The results were similar to those produced using a single year's data. The FY 2007 pass rate using the current formula was 94.1 percent. Using the three-year average increased the rate .3 to 94.4 percent. The change in the FY 2008 pass rate was from 91.2 percent to 91.5 percent.

C. Combining Both Alternative Models

The third alternative model combined the removal of the capping convention along with a three-year rolling average of the Net Income Ratio. Again, results were similar to those produced using the department's current methodology. False negative scores were not significantly reduced. The FY 2007 pass rate was 94.1 percent using the current method and 94.7 percent combining both alternatives. The difference in FY 2008 was between 91.2 percent and 92.4 percent.

S P O T L I G H T

A **small religiously-affiliated college** with a $41 million budget and a $100 million endowment regularly had composite scores above 2.0. Then the college was hit hard by the stock market collapse in 2008, suffering over $25 million in losses on its endowment.

The Department followed the regulations correctly in calculating the college's ratios. However, the size of the loss relative to the college's budget caused both the primary reserve ratio and net income ratio to fall into negative territory, resulting in a failing composite score of 0.6.

Still, the college was not in dire straits nor headed towards closure - and certainly not precipitous closure. There were no systemic operational problems and, even after the losses, the college had endowment assets of more than $70 million -- $140,000 per student.

If the calculation of the primary reserve ratio had taken into account all of the institution's assets -- especially the expendability of its endowment -- the college would have received a higher score reflecting its actual financial condition. Alternatively, if the college had been allowed to demonstrate its financial stability to the Secretary in this special circumstance, it would have avoided both the unnecessary cost of obtaining a letter of credit, and the damage to its reputation from the inaccurate portrayal of its overall fiscal health.

3. Possible Benefit of Eliminating Numerical Scores

The task force considered whether merely using the Department's current qualitative terminology -- "pass," "fail," or "in the zone" -- would provide sufficient information about a nonprofit institution's financial status, and whether numerical, and sometimes misleading, financial responsibility scores need not be made public.

While the use of the categories of "pass," "fail," and "in the zone" and elimination of a numerical ranking system might be marginally beneficial in avoiding comparison of schools, the task force ultimately decided that these terms would still be based on numerical scores derived from mathematical formulas, and such scores are public information. In addition, simply being labeled "failing," without a relative score, might have worse implications than the current system.

4. Use of a "Net Income from Operations" Number

The task force considered a methodology that would include using "net income from operations" in the Net Income Ratio instead of "total change in unrestricted net assets."

While this might provide a more accurate picture of institutions' financial status, the task force determined that its use was currently not feasible because many colleges do not provide this number in their audited financial statements. Although the Financial Accounting Standards Board (FASB) is currently reviewing the possible use of this ratio, concern remains because its value can be artificially inflated if an institution increases its draw on its endowment.

5. Use of a Liquidity Measure

The task force discussed the benefits of using a liquidity measure either as an initial screen, or double check on the financial responsibility score. A basic liquidity measure is one of the most common-sense tools for determining whether an institution has the necessary fiscal resources. Upon analysis, it was determined that since FASB is currently looking at the possibility of requiring disclosure of some measure of liquidity in audited financial statements, any measure used in the federal system should be consistent with those new standards, should they emerge. Therefore, the task force decided not to further pursue the alternative at this time, but does consider it an important factor to consider once FASB finishes its work.

6. Closed Schools

Task force members used various information sources in attempting to compile a list of closed schools. The intent was to review their past financial responsibility composite scores, to assess the predictive value of failing scores. However, public databases on closed schools turned out to be extremely problematic, and information on composite scores prior to recent years is almost non-existent.

Despite these limitations, the task force does note that the intent of the federal law was not to prevent institutions from closing, but rather to ensure that they do so in an orderly manner that protects students and federal funds. The intent was to avoid the precipitous closures of institutions that took place in the for-profit sector in the late 1980s, leaving students in the lurch. The task force did not find any incidences of precipitous closure in the nonprofit sector, but did note that most schools that have received failing scores remain open.

In conducting its work, the subgroup used currently public, Department data on failing scores and the names of closed schools provided in the *Higher Education Directory*. Additional work in this area could be conducted by the Department, through its own data sources.

7. Use of an Adjusted Net Assets Approach to the Calculation of the Primary Reserve Ratio of Nonprofits

The task force considered an alternative formula to calculate the primary reserve ratio for nonprofit colleges and universities that parallels the formula presently used by the Department to calculate the ratio for proprietary schools. This was done to determine the effect of including the value of the institution's endowment, which is excluded from the numerator when calculating the nonprofit primary reserve ratio. While the Department frequently includes endowment losses in the denominator (total expenses) of the nonprofit primary reserve formula, it doesn't include the entire value (all net assets) of the endowment in the numerator. *(See Recommendation # 2.)*

A. The primary reserve ratio for proprietary institutions:

$$\frac{\textbf{Adjusted Equity*}}{\textbf{Total Expenses}}$$

*Adjusted Equity = (total owner's equity) – (intangible assets) – (unsecured related-party receivables) – (net property, plant and equipment) + (post-employment and retirement liabilities) + (all debt obtained for long-term purposes)

B. The primary reserve ratio for nonprofit institutions:

$$\frac{\textbf{Expendable Net Assets*}}{\textbf{Total Expenses}}$$

*Expendable Net Assets = (unrestricted net assets) + (temporarily restricted net assets) – (annuities, term endowments, and life income funds that are temporarily restricted) – (intangible assets) – (net property, plant and equipment) + (post-employment and retirement liabilities) + (all debt obtained for long-term purposes) – (unsecured related-party receivables)

C. ***The alternative primary reserve ratio for nonprofit institutions:***

Adjusted Net Assets*
Total Expenses

*Adjusted Net Assets = (unrestricted net assets) + (temporarily restricted net assets) + (permanently restricted net assets) – (intangible assets) – (unsecured related party receivables) – (net property plant and equipment) + (post-employment and retirement liabilities) + (all debt obtained for long-term purposes)

8. Trials

Two sets of trials were conducted to test the effect of the alternative primary reserve formula in calculating the composite score of nonprofit institutions.

Trial A

The first test used the CIC database of 687 nonprofit baccalaureate and master's level private colleges with data from FY 2007, 2008, and 2009. *(See page 21.)* An initial examination of the financial responsibility test scores compared the use of the alternative formula for calculating the primary reserve ratio to the methodology currently used by the Department. In contrast to other methodologies the task force tested (described above), the use of the alternative formula provided a significant change in the pass rate of nonprofit institutions in 2009, the year in which composite scores reflected the significant losses from 2008-09 in nonprofit colleges' endowments. Modest score improvements also were seen when comparing the Department's current methodology for nonprofits and the alternative method for years that did not reflect a significant market decline.

FY 2007: Pass rate, current method, 95.9% /alternate method, 98.3%

FY 2008: Pass rate, current method, 92.0%/alternate method, 97.2%

The rates for 2009, by comparison, were current method, 78.2%/alternate method, 94.8%.

Trial B

The for-profit formula also was tested using the group of 22 financially vulnerable schools. The pattern was the same as that revealed when using the CIC database. More schools received passing financial responsibility composite scores in 2008, 2010, and 2011 using the proprietary formula than did using the nonprofit formula.

However, the most significant difference was in the 2009 scores which reflected market losses that were included in FY 2009 audited financial statements. Of the 11 schools that failed using the nonprofit model, nine passed using the proprietary model. (One of the schools that passed did close, but not precipitously. Comparative results were not available for one school, and one school improved from a fail to a zone rating.) The five schools that were "in the zone" on the nonprofit formula, passed using the proprietary model. Six schools passed under both assessments.

APPENDICES

Title IV Financial Responsibility Standards
Definition of Composite Score Ratios
Independent (Not-for-Profit) Institutions

(34 CFR, Part 668, Subpt. L, App. B)

Primary Reserve Ratio:

- Provides a measure of an institution's expendable or liquid resource base in relation to its overall operating size
- Measures whether an institution has financial resources sufficient to support its mission:
  1. Sufficient financial reserves to meet current and future operating commitments
  2. Sufficient flexibility in those reserves to meet changes in its programs, educational activities and spending patterns

Equity Ratio:

- Provides a measure of the amount of total resources that are financed by contributions or accumulated earnings
- Captures an institution's overall capitalization structure
- Measures capital resources and ability to borrow

Net Income Ratio:

- Provides a direct measure of an institution's profitability or ability to operate within its means

Formulas:

- **Primary Reserve Ratio** = $\dfrac{\text{Expendable Net Assets}}{\text{Total Expenses}}$
- **Equity Ratio** = $\dfrac{\text{Modified Net Assets}}{\text{Modified Assets}}$
- **Net Income Ratio** = $\dfrac{\text{Change in Unrestricted Net Assets}}{\text{Total Unrestricted Revenue}}$

Ratio Component Calculations:

Expendable Net Assets = (unrestricted net assets) + (temporarily restricted net assets) – (annuities, term endowments and life income funds that are temporarily restricted) – (intangible assets) – (net property, plant and equipment) + (post-employment and retirement liabilities) + (all debt obtained for long term purposes) - unsecured related party receivables

Total Expenses = the total unrestricted expenses taken directly from the audited financial statement

Modified Net Assets = (unrestricted net assets) + (temporarily restricted net assets) + (permanently restricted net assets) – (intangible assets) – (unsecured related party receivables)

Modified Assets = (total assets) – (intangible assets) – (unsecured related party receivables)

Change in Unrestricted Net Assets is taken directly from the audited financial statement

Total Unrestricted Revenue is taken directly from the audited financial statement (and includes net assets released from restriction during the fiscal year).

ABCD....F?

Will Your Institution Pass the Financial-Responsibility Test?

BY KENT JOHN CHABOTAR

LAST AUGUST, THE U.S. DEPARTMENT OF EDUCATION disclosed that 149 nonprofit private colleges and universities had failed its "financial-responsibility test" for fiscal year 2008–09. The institution where I serve as president, Guilford College, was among them. That led me and the board of trustees to study the test, its methodology, and its results with more than passing interest.

TAKEAWAYS

1 In an era of rankings and ratings, the Department of Education's financial-responsibility test is sparking attention. If your institution's score is below 1.5, you will be subjected to special controls and reporting requirements to participate in federal financial-aid programs.

2 Rather than wait for the score to be published each summer, your institution should estimate in advance what the score will be and decide the best ways to inform various constituencies.

3 Once you verify that the score is accurate for your institution, you should use the information that the test provides to identify areas of financial vulnerability and potential corrective actions.

Although the Education Department has performed this test of an institution's fiscal capacity to administer Title IV federal student-aid programs since 1998, 2010 was only the second year that the results were widely available. The *Chronicle of Higher Education* first made a Freedom of Information Act request to get the data in 2009. Only 114 institutions failed that year. The significant increase in 2010, amidst general economic turmoil, prompted many news-media inquiries and reports that took most of us at private colleges by surprise.

The National Association of College and University Business Officers (NACUBO), independent analysts and consultants, and institutional financial officers have expressed concerns about the test, especially since the failing results were made public. Among those concerns have been misinterpretations or miscalculations of the formulas, use of outdated accounting definitions and standards, and regional inconsistencies. This article explains what the financial-responsibility test is and how it is used, explores what the implications might be for colleges and universities, and suggests how presidents and board members can deal most effectively with the test and public disclosure of a failing score.

What is the financial-responsibility test?

The U.S. government spends billions of tax dollars each year to support higher education. More than $115 billion was spent in FY 2009–10 alone, mostly in the form of grant aid and low-interest loans that colleges and universities disburse to students. KPMG Peat Marwick designed the financial-responsibility test for the Department of Education to identify institutions whose poor financial condition could force them to close precipitously or otherwise put at risk Title IV student-aid funds. The test measures the adequacy of cash flow, budget surplus and deficits, debt, and net worth.

Some key facts about the test:

- The financial health of institutions is assessed based on three ratios: primary reserve, equity, and net income. An institution's raw scores are converted to strength factors, weighted, and combined into a composite score on which public and news-media attention has focused.
- Composite scores range from -1 to +3. Institutions with scores of 1.5 or above "pass." The Department of Education considers them financially responsible without the need for further oversight.
- Institutions with composite scores between 1 and 1.4 are allowed to participate in Title IV under a "zone alternative," under which they are subject to special requirements and enhanced monitoring by the department.
- The Education Department does not permit institutions with scores below 1 to continue participating in Title IV programs without providing additional surety—for example, a letter of credit that guarantees at least 50 percent of the institution's Title IV funding.
- Although subject to other kinds of financial scrutiny, public institutions are not evaluated using the ratio methodology. A public institution is considered financially responsible if it submits a letter from an official of a state or other government entity confirming that the institution is public.
- Proprietary, for-profit institutions are subject to a financial-responsibility test, yet it uses ratios and scoring more suitable to a business organization that recognizes owner's equity, pays taxes, and has other financial components that aren't relevant to private nonprofit colleges and universities.

Even if a college or university passes the test with a composite score of 1.5 or above, the Education Department has other standards that an institution must meet. The institution must have sufficient cash reserves to make refunds and repayments of Title IV funds. It must be current in paying debt service. It must not have a statement in its audited financial statements expressing doubt about its survival as a "going concern" or, unless the department grants an exception, anything other than an unqualified opinion that the audited statement is presented in accordance with generally accepted accounting principles.

How is the test calculated?

For private, nonprofit institutions, the test uses the institution's audited financial statements to calculate three ratios that the Department of Education defines and explains as follows:

Primary reserve ratio. This ratio is defined as expendable net assets (or expendable equity) divided by total expenses. Because this ratio measures expendable resources in relation to operating size, it provides a direct measure of an institution's viability and indirect measure of its liquidity. An expendable resource is, for example, cash, an unrestricted bequest, or a restricted student-aid fund that can be spent as soon as a student who meets the donor's criteria is identified.

Equity ratio. This ratio is defined as net assets (or equity) divided by total assets. Net assets or equity represent the residual worth of an entity—the value of its assets less claims by outside parties. The ratio of equity to total assets can be viewed as the proportion of an institution's assets that the institution owns "free and clear." By measuring expendable and non-expendable resources, this ratio helps to assess an institution's ability to borrow and capital resources. (The permanently restricted principal of an endowment fund exemplifies a non-expendable resources under normal conditions.)

Net income ratio. The net income ratio is defined as the excess of revenue over expenses divided by total revenue. In the for-profit sector, it measures profit or loss. In the nonprofit sector, it provides information useful in assessing an institution's ability to operate within its means.

Upon review, the Education Department may exclude some items from an institution's financial statements in calculating the ratios. Those include extraordinary and presumable one-time gains and losses, questionable accounting treatments such as excessive capitalization or marketing costs, and intangible assets like professorships.

After incorporating strength factors and weighting percentages that the Education Department applies to all private, nonprofit colleges and universities, these three ratios are combined into one final composite score. Strength factors put the scores on a scale from -1 to +3. The Education Department explains that strength factors are designed to assess the extent to which an institution has the financial resources to:

- Replace existing technology with newer technology;
- Replace physical capital that wears out over time;
- Recruit, retain, and retrain faculty and staff members; and
- Develop new programs.

Weighting percentages are then applied to reflect the relative importance of the ratios. Adding the three weighted strength factors together yields one final composite score as shown in Table 1.

For example, this hypothetical university has $20 million in expendable net assets and $100 million in total expenses, or a primary reserve ratio of .20. Multiplying .20 by the strength factor of 10 yields a score of 2 (the score cannot exceed +3. or be less than -1) that is weighted 40 percent or .80 toward the composite score. The total composite score of 1.8 places the institution safely above the 1.5 threshold to be "deemed financially responsible without further oversight."

What happens if an institution fails the test?

Even if an institution fails, the Education Department may consider it to be financially responsible and allow continued participation in student-aid programs if an alternative standard is met. Such an alternative standard might be a:

Table 1. Sample Ratio Methodology

RATIO	INPUTS	RESULT	STRENGTH FACTOR	SCORE	WEIGHT	WEIGHTED SCORE
Primary Reserve	Expendable Net Assets/Total Expenses	0.20	10	2.00	40%	0.80
Equity	Modified Net Assets/Modified Assets	0.30	6	1.80	40%	0.72
Net Income	Change in Unrestricted Net Assets/ Unrestricted Revenue	0.003	1+(50 X Result)[1]	1.15	20%	0.23
					Composite Score	1.75
					Final Score *(rounded)*	1.80

- **Letter of credit.** A college or university may be considered financially responsible by submitting an irrevocable letter of credit from a bank or other financial institution. The letter guarantees repayment of federal student-aid funds in an amount equal to 50 percent of funds that the institution received during its most recently completed fiscal year.
- **Zone alternative**. Institutions that have a composite score between 1 and 1.4 for the fiscal year may choose the zone alternative for up to three consecutive fiscal years. Under this alternative, a college or university must request and receive student-aid funds under special cash-monitoring or reimbursement methods. For example, it must disburse funds to eligible students and parents before requesting reimbursement of those funds from the Department of Education. The institution will also be subject to increased reporting and monitoring. Other sanctions will be imposed if the institution falls below 1 in any one fiscal year or fails to score at least 1.5 at the end of three years.
- **Provisional certification**. If an institution fails to meet one or more of the general standards or is not financially responsible because of an unacceptable audit opinion, the Education Department may permit it to continue participating in student-aid programs under a provisional certification for up to three years. The institution must obtain a letter of credit with a value equivalent of 10 percent or more of the program funds that it received in the prior fiscal year. The institution must also prove that it has met all of its financial obligations and has been current on debt payments for the two most recent fiscal years. Finally, it must submit to greater monitoring of cash, reimbursements, and other financial events. If an institution is still not deemed financially responsible when the provisional certification is scheduled to end, the Education Department may renew the certification but also impose additional controls and monitoring. The department may also declare the institution ineligible for federal student-aid funds, but that rarely happens.

What are concerns about the Education Department test?

Most financial experts agree that the federal government needs to identify institutions in dire financial straits so that Title IV funds are not lost or misappropriated. But many doubt whether the responsibility test actually does that. They have concerns about:

- **The role of endowment losses in a bad economic environment.** Many financially sound colleges and universities had precipitous rating slides simply because an extraordinary market downturn depressed endowment values and total net assets in 2008 and 2009. How else do you explain Harvard University and Yale University at 2.2, Georgetown University at 1.6, and Leon's Beauty School in North Carolina at 3.0?
- **The limits that the financial-responsibility test places on the strength-factor scores of -1 to +3 may distort such results.** Those limits do not allow majestic strength or catastrophic weakness in one ratio to have its full effect on the other ratios. For example, in fiscal year 2009–10, Harvard's primary reserve strength-factor score was actually 54.3, but it was capped by the financial-responsibility test at 3.
- **Accounting standards.** Others question whether the test conforms to the latest accounting standards, is interpreted consistently by Department of Education financial analysts, and defines terms in conformity with the latest generally accepted accounting principles. For example, among the issues that NACUBO has cited with the financial-responsibility standards are:
    1. By adding unrealized investment losses to total expenses in the primary reserve ratio, the Education Department is double counting losses because both expenses and losses have already reduced unrestricted net assets.
    2. The department does not consider revolving lines of credit, state working-capital loan programs, and other debt as long term, even though the debt is not scheduled to be repaid within the next fiscal year and it has been classified as long-term debt on the audited financial statements.
    3. The department fails to include pension benefits as part of "postemployment and retirement benefits." The long-term portion of such obligations is added to the institution's spendable assets in calculating the ratios.
    4. The department will disallow pledges from board members unless trustees perform the role of trustee only and do not have other business relationships with the institution.
- **Other issues.** In addition, people have cited the misinterpretation of the test's purpose and results. Rather than identifying institutions in financial crisis on what is essentially a pass/fail basis, journalists and others have used the test results as a financial version of the *U.S. News & World Report* rankings. They have compared colleges and universities as if institution X with a score of 2.3 is more financially sound than institution Y with a score of 2. But rankings and other summary judgments about relative financial health should not be based on small differences, especially when many aspects of the financial-responsibility test are questionable.

Such uncertainties led the National Association of Independent Colleges and Universities (NAICU) to issue a statement

Appendix B - Page 3

following the publication of the fiscal year 2008–09 list in August 2010.

The financial-responsibility list issued by the U.S. Department of Education today confirms what most Americans have known the past few years: we have an economic downturn that has affected investment portfolios throughout America, whether the portfolios are those of families, businesses, colleges, or other organizations.... In many cases, colleges only appear on the list because of accounting methods that do not consider the institution's overall resources .... Others appear on the list based on the day the snapshot was taken, and today would pass the test with flying colors.

NAICU has appointed a task force that I chair to study the accuracy and reliability of the financial-responsibility test and to recommend improvements to the Department of Education. Members of the task force include senior officials from NACUBO, the Council of Independent Colleges, state independent college associations, and individual institutions. We expect to have recommendations later in 2011.

What should trustees and presidents do?

Regardless of whether the financial-responsibility test is changed, institutional leaders should pay attention to it. The three ratios can disclose important information about financial conditions. And even though the composite score may be questionable, it can affect your institution's federal student aid and public perceptions of its solvency and creditworthiness. If your institution fails or falls into the "zone," you will have to answer questions from the news-media, students and families, faculty and staff members, and other constituencies.

Some recommendations for dealing with the test are:

Avoid surprises by estimating your own composite score. Given that the scores for FY 2008–09 were not made public until August 2010, your institution should have sufficient time to estimate its composite score and be prepared to deal with the results. The term "estimate" is used purposely because the Department of Education financial analysts compute the actual score with possibly different or inconsistent interpretation of accounting terms. In any case, your administration and board can be alerted, news-media materials can be developed, and, if your institution fails the test, corrective measures can be identified.

Plan what to do if your institution gets a letter from the Education Department with a failing score. The first thing your institution should do is to verify the accuracy of the finding by double-checking all the numbers. If administrators spot an outright error or a possible misinterpretation, they should inform the department and consider an appeal. Depending on the score and other financial circumstances, they can then decide whether to take on a letter of credit or another alternative to be considered "financially responsible."

Develop a communications plan. Your board should be informed as soon as possible. The institution should then prepare a news release and offer interview opportunities with the president and chief financial officer. A college or university with a transparent financial data and budgeting processes has a better chance of faculty and staff members understanding what the score means and of less panic. Guilford College announced on our Web site that, at 1.4, we were in the "zone" for FY 2008–09, and we invited news-media scrutiny. Of course, the fact that we also disclosed that the auditors estimated a 2.4 for FY 2009–10 received much less attention.

Use individual ratios to understand your institution's financial condition. Despite methodological questions, the ratios can suggest areas of potential strength or weakness. For example, a strength-factor score of 3 on the primary reserve ratio indicates that the institution has expendable resources equal to about 30 percent of total expenses. Put another way, the institution has about 100 days worth of resources to cover current operations. At -1, the institution's liabilities exceed its assets. It suggests potentially debilitating weaknesses in liquidity and viability.

Use an accurate failing score as a springboard for meaningful reforms. If you agree that the score has revealed systemic financial weaknesses, rather than one-time problems caused by extraordinary circumstances, your institution can use the public attention to spur action. Ensuring a balanced budget, aggressive fund-raising, control over expenses and positions, avoiding debt not supported by new revenue, and other steps are elements of sound financial management as well as ways to improve the score.

Colleges and universities will continue to see increasing interest in institutional accountability for costs and outcomes. The financial-responsibility test is another manifestation of that trend, albeit one with potentially high consequences for federal financial aid and public image. Just as French Prime Minister Georges Clemenceau once remarked, "War is too important to be left to the generals," it is also true that the financial-responsibility test is too important to be left to the accountants. Understanding how the test is constructed and used—and how an institution can best respond—should be on the learning agenda of every governing board member. ■

Questions for Trustees

- What is the Department of Education financial-responsibility test and how might it affect federal financial aid at my institution?
- Besides the composite score, what are the other standards that the institution must meet to be considered financially responsible?
- What concerns have been expressed about the test that may change how we interpret the results and our financial condition?
- What should the board and the president do if the department informs us we have failed the test?

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E-MAIL: chabotar@guilford.edu
T'SHIP LINKS: Scott Schulick and Cynthia E. Anderson,"On Track for the Future: A Case Study in Strategic Finance." November/December 2010. Terry W. Hartle, "Coming Soon: Lots More Federal Regulations." November/December 2008.
OTHER RESOURCE: NACUBO Composite Financial Index Worksheet, http://www.nacubo.org/documents/business_topics/CFI_Other_Ratios_and_Trend_table.xls

Subpart 3—Eligibility and Certification Procedures

SEC. 498. [20 U.S.C. 1099c]. ELIGIBILITY AND CERTIFICATION PROCEDURES.

(c) FINANCIAL RESPONSIBILITY STANDARDS.—(1) The Secretary shall determine whether an institution has the financial responsibility required by this title on the basis of whether the institution is able—

(A) to provide the services described in its official publications and statements;

(B) to provide the administrative resources necessary to comply with the requirements of this title; and

(C) to meet all of its financial obligations, including (but not limited to) refunds of institutional charges and repayments to the Secretary for liabilities and debts incurred in programs administered by the Secretary.

(2) Notwithstanding paragraph (1), if an institution fails to meet criteria prescribed by the Secretary regarding ratios that demonstrate financial responsibility, then the institution shall provide the Secretary with satisfactory evidence of its financial responsibility in accordance with paragraph (3). Such criteria shall take into account any differences in generally accepted accounting principles, and the financial statements required thereunder, that are applicable to for-profit, public, and nonprofit institutions. The Secretary shall take into account an institution's total financial circumstances in making a determination of its ability to meet the standards herein required.

(3) The Secretary shall determine an institution to be financially responsible, notwithstanding the institution's failure to meet the criteria under paragraphs (1) and (2), if—

(A) such institution submits to the Secretary third-party financial guarantees that the Secretary determines are reasonable, such as performance bonds or letters of credit payable to the Secretary, which third-party financial guarantees shall equal not less than one-half of the annual potential liabilities of such institution to the Secretary for funds under this title, including loan obligations discharged pursuant to section 437, and to students for refunds of institutional charges, including funds under this title;

(B) such institution has its liabilities backed by the full faith and credit of a State, or its equivalent;

(C) such institution establishes to the satisfaction of the Secretary, with the support of a financial statement audited by an independent certified public accountant in accordance with generally accepted auditing standards, that the institution has sufficient resources to ensure against the precipitous closure of the institution, including the ability to meet all of its financial obligations (including refunds of institutional charges and repayments to the Secretary for liabilities and debts incurred in programs administered by the Secretary); or

(D) such institution has met standards of financial responsibility, prescribed by the Secretary by regulation, that indicate a level of financial strength not less than those required in paragraph (2).

(4) If an institution of higher education that provides a 2-year or 4-year program of instruction for which the institution awards an associate or baccalaureate degree fails to meet the criteria imposed by the Secretary pursuant to paragraph (2), the Secretary shall waive that particular requirement for that institution if the institution demonstrates to the satisfaction of the Secretary that—

(A) there is no reasonable doubt as to its continued solvency and ability to deliver quality educational services;

(B) it is current in its payment of all current liabilities, including student refunds, repayments to the Secretary, payroll, and payment of trade creditors and withholding taxes; and

(C) it has substantial equity in school-occupied facilities, the acquisition of which was the direct cause of its failure to meet the criteria.

(5) The determination as to whether an institution has met the standards of financial responsibility provided for in paragraphs (2) and (3)(C) shall be based on an audited and certified financial statement of the institution. Such audit shall be conducted by a qualified independent organization or person in accordance with standards established by the American Institute of Certified Public Accountants. Such statement shall be submitted to the Secretary at the time such institution is considered for certification or recertification under this section. If the institution is permitted to be certified (provisionally or otherwise) and such audit does not establish compliance with paragraph (2), the Secretary may require that additional audits be submitted.

(6) (A) The Secretary shall establish requirements for the maintenance by an institution of higher education of sufficient cash reserves to ensure repayment of any required refunds.

(B) The Secretary shall provide for a process under which the Secretary shall exempt an institution of higher education from the requirements described in subparagraph (A) if the Secretary determines that the institution—

(i) is located in a State that has a tuition recovery fund that ensures that the institution meets the requirements of subparagraph (A);

(ii) contributes to the fund; and

(iii) otherwise has legal authority to operate within the State.

AUDIT & AUDIT REVIEW PROCESS

Having the audit performed

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

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

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

Review of FSA audit submissions

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

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

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

Access to records

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

Use of eZ-Audit required

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

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

Information about eZ-audit

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

Cooperation with audit & review process

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

eZ-Audit

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

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

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

The eZ-Audit process

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

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

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

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

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

Third-party servicers

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

AUDITS FOR THIRD-PARTY SERVICERS

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

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

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

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

DEMONSTRATING FINANCIAL RESPONSIBILITY

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

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

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

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

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

Financial reponsibility for public schools

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

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

Financial responsibility for proprietary or private nonprofit schools

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

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

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

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

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

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

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

STANDARDS FOR FINANCIAL RESPONSIBILITY

Composite score

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

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

Refund reserve standards

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

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

Financial responsibility

Treatment of long-term debt
DCL GEN 03-08, July 2003
34 CFR 668, Subpart L, Appendices A & B
Ratios
34 CFR 668.171(b)(3)
Refund reserve standard
34 CFR 668.173
Returning funds
34 CFR 668.172(c)
For withdrawn students, returns funds in a timely manner
34 CFR 668.22

Additional information on composite scores

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

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

Tuition recovery funds

When a state submits a tuition recovery fund for approval by the Department, the Department will consider the extent to which the recovery fund:
• provides returns to both in-state and out-of-state students;
• complies with FSA requirements for the order of return of funds to sources of assistance; and
• is replenished if any claims arise that deplete the fund.

Calculating a composite score

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

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

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

A strength factor score is then calculated for each ratio using equations established by the Department. A strength factor score reflects a school's relative strength or weakness in a fundamental element of financial health, as measured by the ratios. Specifically, the strength factor scores reflect the extent to which a school has the financial resources to: 1) replace existing technology with newer technology; 2) replace physical capital that wears out over time; 3) recruit, retain, and retrain faculty and staff (human capital); and 4) develop new programs.

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

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

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

Exclusions

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

(1) Generally excludes extraordinary gains or losses, income or losses from discontinued operations, prior period adjustments, the cumulative effect of changes in accounting principles, and the effect of changes in accounting estimates;

(2) May include or exclude the effects of questionable accounting treatments, such as excessive capitalization of marketing costs;

(3) Excludes all unsecured or uncollateralized related-party receivables;

(4) Excludes all intangible assets defined as intangible in accordance with generally accepted accounting principles; and

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

(i) In the notes to the institution's audited financial statement, or as a separate attestation, the auditor discloses by name and CFDA number, the amount of HEA program funds reported as expenses in the Statement of Activities for the fiscal year covered by that audit or attestation; and

(ii) The institution's composite score, as determined by the Secretary, is less than 1.5 before the reported expenses arising from those HEA funds are excluded from the ratio calculations.

34 CFR 172(c)

Returning funds in a timely manner

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

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

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

Compliance thresholds for timely return of funds

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

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

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

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

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

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

Deposit to operating account or separate federal bank account

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

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

34 CFR 668.163(a)

Return of Title IV funds

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

Making new awards with returned funds

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

Address for Letters of Credit

Letters of credit are submitted to:

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

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

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

Exceptions to the letter of credit requirement

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

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

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

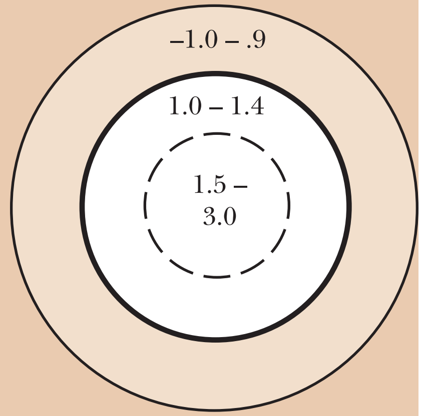
A school that submits an appeal, together with all required supporting documents, by the date the letter of credit would be due is not required to submit a letter of credit unless the Department notifies the school that its request has been denied.

Current in debt payments

A school is not current in its debt payments if

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

Composite score scale



1.5 to 3.0 Financially responsible without further oversight.

1.0 to 1.4 In the "Zone." The school is considered financially responsible, but additional oversight is required.

–1.0 to .9 Not financially responsible. The school must submit a letter of credit of at least 50% of its FSA funding. The school may be permitted to participate under provisional certification with a smaller letter of credit—with a minimum of 10% of its FSA funding and additional oversight.

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

Calculation of Ratios

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

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

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

Calculation of Strength Factor Score

Primary Reserve Strength Factor Score = 20 x 0.080 = 1.600	20 x Primary Reserve Ratio
Equity Strength Factor Score = 6 x 0.332 = 1.992	6 x Equity Ratio
Net Income Strength Factor Score = 1 + (33.3 x 0.051) = 2.698	1 + (33.3 x Net Income Ratio)

Calculation of Weighted Score

Primary Reserve Weighted Score = 0.30 x 1.600 = 0.480	30% x Primary Reserve Strength Factor Score
Equity Weighted Score = 0.40 x 1.992 = 0.797	40% x Equity Strength Factor Score
Net Income Weighted Score = 0.30 x 2.698 = 0.809	30% x Net Income Strength Factor Score

Composite Score

Sum of All Weighted Scores 0.480 + 0.797 + 0.809 = 2.086 rounded to 2.1

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

ALTERNATIVES TO THE GENERAL FINANCIAL STANDARDS

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

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

Letter of credit alternative for new school

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

Letter of credit alternative for participating school

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

Zone alternative

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

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

Alternative standards and requirements
34 CFR 668.175

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

The school may also be required to:
• submit its financial statement and compliance audits earlier than the time specified under 34 CFR 668.23(a)(4); and
• provide information about its current operations and future plans.
34 CFR 668.175(d)(2)

Under the zone alternative, a school—

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

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

Provisional certification for school not meeting standards

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

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

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

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

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

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

If a school is still not financially responsible at the end of a period of provisional certification, the Department may again permit provisional certification. However, the Department may require the school or persons or entities that exercise substantial control over the school to submit financial guarantees to the Department to satisfy any potential liabilities arising from the school's FSA program participation. The same persons may be required to agree to be jointly and severally liable for any FSA program liabilities.

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

Provisional certification for school where persons or entities owe liabilities

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

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

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

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

SUPPLEMENTAL READING

Chronicle of Higher Education
August 11, 2010

149 Nonprofit Colleges Fail Education Department's Test of Financial Strength

By Goldie Blumenstyk and Alex Richards

A total of 149 private nonprofit colleges failed the U.S. Department of Education's "financial-responsibility test" based on their condition in the 2009 fiscal year, data released on Thursday show. That's 23 more than the 126 that failed the test in the 2008 fiscal year, and an increase of about 70 percent over the number of degree-granting institutions that failed two years ago.

The colleges include small, religious institutions like Crossroads College, in Minnesota, and Concordia Seminary, in Missouri; specialized institutions like the Pennsylvania Academy of the Fine Arts, the Milwaukee Institute of Art & Design, and the Dorothea Hopfer School of Nursing, at Mount Vernon Hospital, in New York; and several residential and liberal-arts colleges, including Belmont Abbey, Bethel, Guilford, Harcum, Keuka, and Ripon.

Among for-profit colleges, 37 failed the test for 2009, 11 fewer than for 2007. Nine of them had the lowest possible score.

Colleges that fail the test are subject to additional federal scrutiny of student-aid funds and, in cases of the lowest scores, extra financial obligations.

More than a third of the nonprofit colleges that failed the test in 2009 are located in nine states in the Midwest, with 13 in Illinois, the analysis showed. Another 13 are in Pennsylvania, 12 in New York, and 11 in California. (See interactive map for details on past three years.)

A *Chronicle* analysis also found that 34 of the nonprofit institutions on the list for 2009 failed the test in each of the previous two years as well. (The accompanying interactive table shows scores for all degree-granting institutions that failed the test in any of the three years, as well as the number of years in which they've done so.)

Failing the test is typically an indicator of a college's overall financial fragility. But for 2009, several of the nonprofit institutions said their presence on the list was due chiefly to steep declines in their endowment values. "If the market hadn't gone down, we wouldn't be a one," said Mary M. de Regnier, vice president for finance at Ripon College, referring to its score. Ripon fell below the passing score of 1.5 but above the level at which it would be required to post a letter of credit with the Department of Education. The college said it could do so without hurting its liquidity.

Rockhurst University, in Missouri, which scored 0.9, said endowment losses, the way it accounts for interest contracts on its debt, and a training company it owns that "racked up a loss last year," as the economy faltered, were all factors in its low score. "We'll be better this year," said Guy Swanson, vice president for business and finance.

Scores, which run from minus 1.0 to 3, are based on a calculation that takes several factors into account, including debt, assets, and operating deficits and surpluses.

Takeover Targets?

A failing score has also become a signal to investors that an institution could be ripe for a for-profit takeover. At least one of the colleges that appeared on the list of "failed" institutions first published by *The Chronicle*, in June 2009, doesn't appear on the list for the 2009 fiscal year; the institution, National Hispanic University, in California, was sold to Laureate Education Inc. Waldorf College, in Iowa was also sold. Its purchase, by the for-profit Columbia Southern University took place after the end of the fiscal year and the college appears on the nonprofit list for 2009.

The list for 2009 includes Dana College, in Nebraska, which recently announced that it would close, after its accreditor said it would not automatically continue its accreditation under the corporate owners that had hoped to buy it. (Two other institutions known to be in talks with buyers, Lambuth University, in Tennessee, and Rochester College, in Michigan, don't appear in the Education Department's data files for 2009, presumably because they are among the 115 or so degree-granting for-profit and nonprofit institutions whose scores are still being processed by the department.)

Last year the *Chronicle* obtained its list of 114 degree-granting nonprofit institutions in response to a Freedom of Information Act request. That list was based on Education Department data that did not reflect all colleges' most current fiscal year, or adjustments to scores the department was in the process of compiling. This year the department did not release scores until all colleges had submitted current information and had a chance to resolve questions about their scores.)

In addition, the department also released all scores for all nonprofit and for-profit colleges for the previous two years. The information is available at the department's data center Web site. Officials said they were releasing the data to give the public more information about colleges and in response to the interest resulting from the *Chronicle*'s publication of the list last year. Public colleges, because of their government support, typically aren't subject to the assessment, which is designed to assure taxpayers that their money is not at risk.

Colleges that score 1 to 1.4 on the test are considered to have failed but are "in the zone," meaning they can continue to participate in federal financial-aid programs, but with restrictions on how student-aid funds are disbursed to them.

Colleges with scores below 1 are subject to extra requirements. They must post letters of credit equal to at least 10 percent of the federal student-aid funds they receive and face additional restrictions, or post letters of credit equal to at least 50 percent of the funds they receive and operate as if they had passed the test. Colleges that score 1 through 1.4 for three consecutive years become subject to the extra requirements.

Department officials said they rarely kicked colleges out of student-aid programs altogether, because the restrictions and letter-of-credit requirements are adequate protections for taxpayers' money if a college falls into dire financial straits.

In 2009 more than half of the failing nonprofit colleges—80 of them—scored low enough to trigger the extra requirements, up from 71 in 2008 and 48 in 2007. Among for-profit colleges, the trend was reversed; 24 scored that low in 2009, down from 33 in 2008 and 39 in 2007.

Trying to Improve

Several of the colleges with low scores said they were taking steps to improve their financial situation. A branch of City College, in Casselberry, Fla., scored the lowest possible score in each of the past three years. The college's lawyer said that it had been a separately owned two-year institution managed by City College, but that this year City College has absorbed it, and its enrollment, which had fallen to about 73 in 2006, is now above 300.

Officials of Ave Maria School of Law, which has failed the test for three years and had a score of minus 0.9 in 2009, issued a statement that its relocation to Naples, Fla., was helping to improve both its appeal to students and its fund raising. The law school, which has graduated just seven classes, said that its asset-to-debt ratio was still low, but that it expected the ratio to "reverse itself over time" as the school builds its endowment.

The vice president for finance at Eureka College, Marc P. Pasteris, said the Illinois institution has struggled with finances for decades and had been on course for a turnaround since 2005, under a tuition-pricing plan designed to eliminate most discounts, and improve retention. In the previous two years, Eureka reached scores of 1.4, but it fell to 0.8 in 2009 because of endowment losses. "We are not out of the woods," Mr. Pasteris said, "but on the right track."

As in the past, some institutions end up being subject to extra scrutiny by the department or additional student-aid-disbursement requirements because of the way the department accounts for particular transactions.

The president of Bryant & Stratton College, one of the for-profit institutions that reached the list in 2009 (with a score of 0.2), said it did so because of the way it accounts for the capital brought in by new investors and the equity granted to them.

A nonprofit, Alliant International University, said a building on its San Francisco campus, which it sold a few years ago and is now leasing back from the owner, pushed down its score. Alliant appeared on the list last year with a score of 1.4 and this year with 1.3. It's "not a list we want to be on," said Geoffrey M. Cox, the president.

In a recent *Chronicle* commentary, Mr. Cox noted that his university had received at least six unsolicited inquiries from investors in the past few months. It's not interested in selling itself, he added.

August 13, 2010: This article has been revised to reflect the following correction: Because of inaccurate information provided by the Education Department, Harding College, in Arkansas, was mistakenly included on the list of institutions that failed the department's test of financial strength in 2008-9. Harding received a composite score of 1.7, not 1.1, and has been removed from the list.

Chronicle of Higher Education
September 7, 2011

Education Dept. Miscalculates 'Financial Responsibility' Scores, Private Colleges Say

By Goldie Blumenstyk

Washington

This month, the U.S. Department of Education will publish the annual financial-responsibility scores of thousands of private colleges. The scores are one of the few publicly available, broad-based indicators of individual institutions' financial health. Or are they?

According to three major higher-education associations and several colleges and private accountants, the scores are often inaccurate and misleading, because the department misapplies its own rules when making its calculations.

The critics also contend that aspects of the 14-year-old formula used to calculate the scores are flawed and outdated.

For more than a year, groups including the National Association of College and University Business Officers and the National Association of Independent Colleges and Universities have pressed the department to re-examine how it calculates the scores. They are derived from the audited financial statements that colleges are required to submit annually to the department. The scores are important because they help determine whether and how freely colleges can participate in federal student-aid programs.

The business officers' group has documented five areas where, it contends, the department is miscalculating the scores. And the private-college association says the department's inconsistent application of formulas among its 10 regional offices compounds the unreliability of the scores as a measure of colleges' financial health.

"There could be schools on the list that shouldn't be on the list, and there could be schools that should be on the list that aren't," says Sarah A. Flanagan, vice president for government relations and policy at the private-college group, known as NAICU.

The scores, which run from 3.0 to minus 1.0, were devised to identify colleges in financial trouble. Over the past two years, several colleges with low scores have been acquired by other parties, suggesting that the list has become a tool for private investors seeking financially ailing colleges that could be ripe for a takeover.

But NAICU contends that the Education Department's misapplication of its own rules has given a false impression of the number of colleges on the brink. The data for the 2009 fiscal year showed 149 private degree-granting institutions received composite scores of 1.5 or below, the cutoff for passing the test. "There's just not 150 schools that are at the risk of closure, or even close to that," Ms. Flanagan says.

She and other critics say that, for 2009 in particular—a year of significant losses for investors—the department's treatment of endowment declines (it counts a decline in endowment value as if it were an expenditure) improperly put many more colleges on the "failed" list than should have been there.

The department maintains that it applies the regulations consistently with its interpretation of them. In a letter to NACUBO, the business officers' group, it provided a point-by-point rebuttal to the arguments raised by that organization.

Serious Consequences

Although the higher-education groups' disagreements with the department over the scores focus largely on arcane principles best understood by accountants—whether to classify a college's line of credit as short-term or long-term debt, whether endowment losses should count as "total unrestricted expenses"—the ramifications are much bigger.

Colleges with scores below 1.5 are subject to tighter monitoring for their federal student-aid funds. Those with scores below 1.0 are required to post costly letters of credit to remain eligible for financial-aid programs. Colleges that consistently fail the test can be denied the right to issue federal aid to their students.

For some institutions, the publication of the scores becomes a public-relations concern as well.

When Guilford College, in North Carolina, showed up on the list for 2009 with a score of 1.4, "we were on the front page" of the local newspaper, says its president, Kent J. Chabotar. A former college finance officer, Mr. Chabotar is part of a group organized by NAICU, NACUBO, and the Council of Independent Colleges that is studying the financial-responsibility score and the department's application of it.

There is value in the scores if they're accurate, he says, but as currently applied, the scores are a source of "misplaced public scrutiny."

The department has produced the scores since 1998, but the higher-education groups say it was only after the scores were made public, two years ago, that the critics began to discover what they say are widespread problems. In 2009, *The Chronicle* obtained scores for all colleges under a Freedom of Information Act request and published a comprehensive list of those with failing scores. Last year the department decided to release the scores annually for all institutions on its own Web site. (The release of the latest round of scores, covering the 2010 fiscal year, is expected this month, but the date has not yet been set.)

Before the publication of the scores, colleges often didn't even know how the calculation had turned out unless they failed, Ms. Flanagan says. Colleges don't even necessarily know how the department crunches the numbers, she adds.

Problem Areas

In conducting its own analysis, NACUBO says it has identified five areas where it believes the department is misapplying its own formula in ways that are "contrary to the letter and spirit" of the 1997 rules that established the scores.

In addition to the questions over how endowment losses are treated, most of the disagreements involve whether colleges are improperly penalized for things like the way they've structured their debt, or how they account for such liabilities as the long-term cost of pensions.

Dale C. Larson, chief financial officer at the Dallas Theological Seminary, says he has no dispute with counting an institution's annual cost of providing those pensions. But he says it is wrong to treat the entire unfunded liability of a pension as a single year's expense—as the Education Department did for his institution in 2009. That resulted in a score of 1.0. "I never should have been in the failed category," he says.

In its rebuttal to NACUBO, the department says it is following the law in accounting for pensions.

NACUBO has also taken issue with the department's hard line on counting pledged donations from trustees. If the trustee is also doing business with the college, the department may consider the pledge as a transaction from a "related party" and not count the entire pledge as an asset. NACUBO says the department is applying a standard for "related-party transactions" that is appropriate in the for-profit sector, but not for nonprofit institutions.

The Association of Private Sector Colleges and Universities says its members have raised no issues about how the department calculates scores for their institutions.

Ms. Flanagan, of NAICU, argues that the rules themselves need to be updated. For example, she says, while laws enacted in the past few years in most states allow nonprofit organizations greater flexibility in how they spend their endowments, the department's formula doesn't reflect that new leeway in its calculation of colleges' assets.

Department officials have said they are willing to consider changes in the formula but haven't made it a top priority. Ms. Flanagan says the groups are frustrated by the inaction but understand the situation. "Right now, they've got a lot to worry about that we also want them to worry about, like the student-aid programs," she says. "Our hope is that if we come up with an alternate solution," department officials will consider it.

Meanwhile, endowments at many colleges are gradually recovering from their 2009 lows, and the groups expect fewer institutions to find themselves on the hot seat when the scores for 2010 become public. This year, says Ms. Flanagan, "we are guessing the list will be smaller."

GLOSSARY

GLOSSARY OF TERMS

Accrediting Agency - Legal entity that conducts accrediting activities through voluntary, non-Federal peer review and makes decisions concerning the educational quality of institutions or programs, or both. In order to be eligible to participate in federal student aid programs, an institution must be accredited by an agency that is recognized by the Department of Education.

Actuarial Losses - Loss arising from the difference between estimates and actual experience in an entity's pension plan. (Actuarial gains and losses are used when accounting for pension plans because of the need to make assumptions about the future rate of salary increases, the length of employee tenure, an appropriate discount rate for the plan obligations and the expected rate of return on plan assets.)

Annuities - A contract between a contributor and a financial entity that is designed to meet retirement and other long-range goals, under which the contributor receives a lump-sum payment or series of payments at some future point. In planned giving annuity arrangements, a donor may transfer assets to a college or university with an agreement that the institution will make payments to a designated beneficiary or beneficiaries, for a certain period of time, or until the death of the beneficiary/ies. The assets are general assets of the institution and the liability to the beneficiary/ies is a general liability of the institution. Adjustments to the liability to reflect amortization of the discount, revaluations of the present value of the estimated future payments to the beneficiaries, and changes in actuarial assumptions is recognized in the statement of activities as a change in the value of split-interest agreements.

Cash Monitoring - The Department of Education's cash monitoring payment method is similar to the reimbursement payment method, but less onerous. A school placed on Heightened Cash Monitoring (HCM) must make disbursements to eligible students and parents before it may request or receive funds for those disbursements from the Department. However, unlike the reimbursement payment method, where a school must provide detailed documentation for each student, the Department provides funds to a school in a less restrictive way.

Cohort Default Rate (CDR) - Percentage of an institution's loans that went into repayment in one fiscal year, that then defaulted before the end of a subsequent fiscal year (or two succeeding years for new three-year rates). Institutions participating in Title IV programs may face sanctions if their CDR is above a pre-determined level.

Composite Score - In the Department of Education's financial responsibility standard, the composite score combines three financial ratios which are weighted and assigned strength factors to yield a single measure of a school's overall financial health. *(See Appendix D: Department of Education Handbook, page D-6.)*

Construction in Progress (CIP) - The classification of a long-lived asset that is being built/assembled before being placed in service. Entities track expenditures incurred, or funds disbursed, in a special "construction in progress" general ledger account until the asset is completed and placed in service. CIP totals are typically part of the "property, plant and equipment" asset category on the statement of financial position (balance sheet).

Debt Service - An agreed amount of principal and interest a borrower pays periodically on a loan over an agreed amount of time until the loan is repaid.

Disbursement Requirements - The rules according to which an institution pays federal student aid to its students.

Donor-restricted Gifts - Gifts provided to a nonprofit entity that must be used for a specific purpose or over a specific time period. Donor restricted gifts increase either temporarily restricted net assets or permanently restricted net assets. There are often significant accounting, legal, tax, and integrity issues associated with such gifts.

Endowment Fund - An investment fund set up by an institution to provide future financial support. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted. Endowment funds generally are established by donor-restricted gifts and bequests to provide (a) a permanent endowment, which is to provide a permanent source of income, or a (b) term endowment, which is to provide income for a specified period. Typically, the original gift amount must be maintained in perpetuity (for the perpetual support of the entity) while a portion of earnings or appreciation are withdrawn to support ongoing operations or other specified purposes. Endowment funds are unique to nonprofit organizations.

Equity - On a company's balance sheet, the amount of the funds contributed by the owners (or stockholders if the company is publicly traded) plus the retained earnings (or losses). *(See Net Assets.)*

Equity Ratio - One of the ratios used to compute the Department of Education's financial responsibility composite score, intended to measure an institution's capital resources, ability to borrow, and financial viability. *(See Appendix A.)*

Expendable Net Assets - Expendable net assets are those assets that an institution can access and spend to satisfy its obligations. *(See Appendix A.)*

eZ-Audit - A web application that provides institutions with a paperless, single point of submission for financial statements and compliance audits. The Department of Education provides an on-line template for use in submitting financial data via the application.

Failing Composite Score - A score that is less than 1.5.

Financial Accounting Standards Board (FASB) -- The designated private sector organization in the United States that establishes financial accounting and reporting standards. FASB standards are recognized as authoritative guidance for the preparation of financial reports by nongovernmental entities.

Financial Ratios - Financial ratios are calculated from an entity's financial statements (and/or other financial information) as indicators of financial performance. Ratios are analytical tools that can help quantify the status, sources, and uses of an entity's financial resources. There are many standard ratios used to try to evaluate the overall financial condition of an entity. In the case of the Department of Education's financial responsibility scores, three ratios are calculated, assigned strength factors and weights and combined into a single composite score. *(See Appendix D: Department of Education Handbook.)*

Financial Responsibility Standards - Department of Education's financial requirements for institutions that provide or seek to provide federal student aid to their students. *(See Appendix D: Department of Education Handbook.)*

For-profit School (or proprietary school) - A school with the goal and financial structure to make a profit through the business of educating students. Proprietary institutions are not public, nor are they private nonprofit institutions. (They sometimes are referred to as "private," which can cause them to be confused with nonprofit private institutions.) Due to variations in accounting standards for for-profit and nonprofit entities, the Department of Education's financial responsibility standards set different calculations for the two sectors.

GAAP - *See Generally Accepted Accounting Principles.*

Gainful Employment - The Higher Education Act requires that most for-profit programs and certificate programs at nonprofit private and public institutions prepare students for gainful employment in a recognized occupation. The Department of Education recently developed standards for such programs measuring debt levels and repayment rates of students.

Generally Accepted Accounting Principles (GAAP) - The standards of financial accounting that govern financial statement reporting in the United States. GAAP is not a single accounting rule but rather a comprehensive body of many rules that address various transactions. The Financial Accounting Standards Board (FASB) establishes GAAP for nonprofit and commercial entities (including for-profit educational institutions). The rules and procedures that encompass GAAP are complex, have grown in number over time, and continue to evolve annually. Definitions and terminology within these standards for nonprofit and commercial entities sometimes differ based on items that are unique to the specific industry. (See box on page 12 for additional information.)

Historical Gift Value (or historical dollar value) - A term used in relation to an endowment fund to quantify the original value of a gift that is directed by a donor to be held in perpetuity by the receiving organization. Additional gifts by the donor that are also directed to be held in perpetuity add to the historical gift value. Over time, accumulated earnings and appreciation on the original (historical) gift are considered spendable depending on the restrictions placed on the gift by the donor. Prior to the enactment of UPMIFA, nonprofit colleges and universities reflected the spendable portion of the endowment in either (or both) the unrestricted and temporarily restricted net asset classes. Since the enactment of UPMIFA the spendable portion of the fund is reflected in the temporarily restricted net asset class until spent. UPMIFA increases flexibility to maintain spending even in times of market downturn – even if the value of the endowment falls below its historical gift value ("underwater").

Intangible Asset - A nonphysical asset, such as a patent, trademark, copyright, goodwill or name recognition. *(See Tangible Asset.)*

Interest Rate Swap - A derivative in which counterparties exchange cash flow of one party's financial instrument for those of the other party's financial instrument. For example, an institution with variable rate long-term debt may use an interest rate swap to protect against the risk that the variable rate on the debt will increase to a point where the debt service is no longer affordable.

Letter of Credit - Correspondence issued by a bank guaranteeing payment for goods and services; e.g., federal student financial aid received by a school, purchased by the one requesting the letter. An irrevocable letter of credit cannot be cancelled or modified without explicit consent of the affected parties. Letters of credit are in effect only for a specified time period and expire at a pre-determined point. Cost can vary. In the case of federal student financial aid, it is usually based on a percentage of the federal student aid received by the institution and its students.

Liabilities - Obligations of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future. Some liabilities are long-term, such as notes payable that mature over more than a year.

Life Income Funds - A type of planned giving arrangement between a donor and a nonprofit organization. The organization is named as a beneficiary of a trust that generates income to the donor. When the donor dies, the remainder of the trust is released to the organization for restricted or unrestricted use, as determined by the agreement.

Monitoring Requirements - Additional requirements the Department of Education may impose on an institution that does not meet the applicable financial responsibility standards.

Net Assets - A measure of the net worth of a nonprofit organization, defined as total assets less total liabilities, which is classified into three mutually exclusive classes according to the existence or absence of donor-imposed restrictions. *(See unrestricted, temporarily restricted, and permanently restricted net assets.)*

Net Income Ratio - One of the three ratios used to determine the Department of Education's financial responsibility composite score. It measures an institution's ability to operate within its means for the year. *(See Appendix A.)*

Net Property, Plant, and Equipment (PPE) - Tangible, long-lived assets used in an organization's mission related activities that have an estimated useful life longer than one year, typically comprised of the land, buildings, and their contents owned by the institution, as well as library books. The carrying value of the PPE is shown net of accumulated depreciation.

Nonprofit (Not-for-profit) - An organization that uses earned revenue and unearned support (gifts) to achieve its goals or accomplish its mission. While nonprofit organizations are permitted to generate surplus revenues, they must be retained by the organization for its self-preservation, expansion, or plans (rather than distributing them as profit or dividends to owners or shareholders). They have controlling members or boards of directors. Nonprofit colleges and universities are exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code.

Paper Loss - A decline in the value of an endowment (or other such financial fund) that may or may not ultimately be realized at the time that asset is spent or sold.

Passing Composite Score - A score of +1.5 to +3.0.

Perkins Loan Fund - An institutional, revolving student loan fund initially funded by contributions from the federal government and the participating institution.

Permanently Restricted Net Assets (PRNA) - Permanently restricted net assets is the part of the net assets of a not-for-profit organization resulting from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization.

Pledge - A promise made by a donor to provide a future contribution to a nonprofit organization. Because pledges are "promises to give" they are a type of receivable of a nonprofit organization. The maker has a social and moral obligation, and sometimes a legal obligation, to make the promised transfer. Nonprofit organizations are the only types of entities that recognize and record pledges.

Post-employment and Retirement Plan Liabilities - Benefits (such as health care and pensions) provided to former or inactive employees, their beneficiaries, and covered dependents, creating a long-term liability on the entity's financial statements.

Primary Reserve Ratio - One of the three ratios used to determine the Department of Education's financial responsibility composite score. This ratio measures an institution's expendable resources in relation to its overall operating size. The ratio indicates how long an institution can function using expendable resources and/or reserves without relying on additional net assets generated by operations. *(See Appendix A.)*

Proprietary School - *See For-profit Institution.*

Provisional Certification - Certification of an institution to participate in the Department of Education's student aid programs, with restrictions specified in the institution's program participation agreement. It is usually in effect for three years, and is used in a number of circumstances; e.g., when an institution initially applies to participate or when an institution is judged by the Department to be in an administrative or financial condition that might jeopardize its ability to perform its responsibilities.

Ratios Test - Tests used to calculate the financial responsibility score of an institution. Three ratios are used: the primary reserve ratio, the equity ratio, and the net income ratio. *(See Appendix A or Composite Score.)*

Realized and Unrealized Losses - A realized loss stems from a completed transaction such as the sale of an asset for less than its cost. Unrealized losses are those that are shown on an institution's financial statement when the fair market value of investment assets has declined, but the assets have not been sold.

Reimbursement Payment Method - Method under which an institution must first disburse to students and parents the amount of funds those students and parents are eligible to receive under the Federal Pell Grant, Stafford Loan, and campus-based programs before the institution may seek reimbursement from the Secretary of Education for those disbursements. The institution requests the amount of the actual disbursements from the Secretary, identifies the students for whom reimbursements are sought, and shows that students and parents were eligible for the aid.

Related Party Receivables - Money owed to an organization from a related party. Related parties are those that have a common control relationship with an organization's management, principal owners, or family members.

Restricted Net Assets - Net assets with constraints placed on them either externally by creditors, grantors, and contributors, or by law.

Rolling Average - An average calculated over a specified period of time, where the next increment of data is added in and the oldest increment is dropped out.

Stafford Student Loans - Federal student loans available to college and university undergraduate and graduate students who are attending college at least half-time.

Tangible Asset - An asset that has a physical form. Tangible assets include both fixed assets, such as machinery, buildings and land, and current assets, such as inventory. *(See Intangible Asset.)*

Temporarily Restricted Net Assets (TRNA) - The part of the net assets of a nonprofit organization that result from donor gifts or investment income on donor restricted endowment funds that are available for future spending. Except for term endowments *(see below)*, net assets within this class are considered to be spendable reserves that support the organization.

Term Endowments - Funds for which the donor stipulates that the principal may be expended after a stated period of time or upon the occurrence of a certain event. Term endowments are included in temporarily restricted net assets until the term expires.

Title IV - The section of the Higher Education Act that authorizes federal student aid, including student grants, loans, and work study.

Total Assets - The summation of an organization's tangible and intangible economic resources.

Total Expenses - Outflows of funds, using up of assets, or incurring liabilities from delivering goods, rendering services, or carrying out activities that constitute an entity's ongoing major or central operations. Expenses result from the decisions of an entity's managers about the activities to be carried out and about how and when particular resources are to be used. Expenses do not include losses, which are decreases in net assets from peripheral or incidental transactions, e.g., endowment losses, losses on the value of pension trust funds, losses on the fair value of interest rate swaps. *(See Appendix A.)*

Uniform Prudent Management of Institutional Funds Act (UPMIFA) - Model state law which governs the expenditure and investment practices of charitable institutions related to donor-restricted endowment funds. *(See box, page 19.)*

Unrestricted Net Assets (URNA) - The part of the net assets of a nonprofit organization that is neither permanently nor temporarily restricted by donor-imposed stipulations. Unrestricted net assets generally result from revenues from providing services; producing and delivering goods; unrestricted contributions; and dividends or interest from investing in income-producing assets, less liabilities. *(See Temporarily Restricted Net Assets, and Permanently Restricted Net Assets.)*

UPMIFA - *See Uniform Prudent Management of Institutional Funds Act.*

Zone Alternative ("In the Zone") - Provisions in the financial responsibility standards under which an institution that receives a financial score of 1.0 to 1.4 ("In the Zone") may continue to participate in the Department of Education's student aid programs but with certain restrictions. This is regarded as a failing score, but the institution is considered sufficiently financially responsible to participate with additional oversight. *(See Appendix D: Department of Education Handbook, page D-10.)*

Sources of Information: *Various Department of Education publications; online accounting definition sources; practicing accountants; and accompanying appendices, as cited.*