DEPARTMENT OF EDUCATION

34 CFR Part 668

RIN 1840–AC36

Student Assistance General Provisions

AGENCY: Department of Education.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: The Secretary proposes to amend the Student Assistance General Provisions regulations by revising the requirement for compliance audits and adding a new subpart establishing financial responsibility standards. The proposed regulations would improve the Secretary's oversight of institutions participating in programs authorized by title IV of the Higher Education Act of 1965, as amended.

DATES: Comments must be received on or before November 4, 1996.

ADDRESSES: All comments concerning these proposed regulations should be addressed to: Mr. David Lorenzo, U.S. Department of Education, P.O. Box 23272, Washington, D.C. 20026, or to the following internet address: fin__resp@ed.gov

A copy of any comments that concern information collection requirements should also be sent to the Office of Management and Budget at the address listed in the Paperwork Reduction Act section of this preamble.

A copy of the report prepared by the firm of KPMG Peat Marwick, LLP (KPMG) referred to in this Notice of Proposed Rulemaking (NPRM) is available for inspection during regular business hours at the following address: U.S. Department of Education, 7th and D Streets S.W., Room 3045, ROB–3, Washington, D.C.

FOR FURTHER INFORMATION CONTACT: Mr. Francis Meyer or Mr. Keith Kistler, U.S. Department of Education, Financial Analysis Branch, Institutional Participation and Oversight Service, 600 Independence Avenue, S.W., Room 3522 ROB–3, Washington, D.C. 20202, telephone (202) 708–4906, for questions regarding financial analysis and other technical questions related to accounting and audits. For other information contact Mr. John Kolotos or Mr. David Lorenzo, U.S. Department of Education, 600 Independence Avenue, S.W., Room 3045 ROB–3, Washington, D.C. 20202, telephone (202) 708–7888. Individuals who use a telecommunications device for the deaf (TDD) may call the Federal Information Relay Service (FIRS) at 1–800–877–8339 between 8 a.m. and 8 p.m., Eastern standard time, Monday through Friday.

SUPPLEMENTARY INFORMATION: The Student Assistance General Provisions regulations (34 CFR part 668) apply to all institutions that participate in the student financial assistance programs authorized by title IV of the Higher Education Act of 1965, as amended (title IV, HEA programs).

The Secretary proposes to revise subpart B as follows: the proposed regulations would eliminate the financial report currently required in § 668.15; revise § 668.23, and include the audit exceptions and repayments requirements now contained in § 668.24 in the new § 668.23. The Secretary also proposes to add a new Subpart L to part 668 by replacing and significantly changing the current ratio standards contained in § 668.15 to include an expanded financial ratio analysis, and standards based on that analysis, as primary tests of financial responsibility; clarify guidance on the entity required to demonstrate financial responsibility; set standards for submitting documentation and demonstrating financial responsibility for foreign institutions; set standards for submitting documents and demonstrating financial responsibility for institutions undergoing a change of ownership; clarify the type of late-refund finding that triggers the refund letter of credit provisions; and make changes to one alternative means of demonstrating financial responsibility.

Tests of financial responsibility based on audited financial statements are necessary to ensure that institutions participating in the title IV, HEA programs possess sufficient financial resources to provide the educational services for which students contract, provide the human and capital resources necessary to administer the title IV, HEA programs, and provide the financial and technical resources necessary to act as a fiduciary for title IV, HEA program funds.

The Secretary intends to issue final rules that will make technical amendments to the appropriate sections of part 668 on or before December 1, 1996, to eliminate conflicting references between those regulations and the proposed § 668.23 and the proposed subpart L of the General Provisions regulations, and to otherwise harmonize the requirements of the proposed § 668.23 and the proposed subpart L with other Federal audit and financial responsibility requirements. In this regard, the Secretary has identified throughout the discussion of proposed changes the major sections of part 668 that would be amended and consolidated.

Background

Statutory and Regulatory History

The authority to establish reasonable standards of financial responsibility for purposes of determining an institution's eligibility to participate in title IV, HEA programs was first granted the Commissioner of Education by the Education Amendments of 1976—Pub. L. 94–482. The statute was subsequently amended in 1983, 1987, and 1992, mostly with regard to the nature and provision of financial audits.

As a result of the 1992 amendments, the statute currently requires the Secretary to:

- Develop standards to ensure that an institution is able to provide educational services and the necessary administrative resources to comply with program requirements, and that the institution meets its financial obligations (particularly in the area of refunds);
- Determine an institution's financial responsibility on the basis of an examination of operating losses, net worth, operating fund deficits, and asset to liability ratios that takes into account the differences in generally accepted accounting principles that are applicable to for-profit and non-profit institutions;
- Determine whether an institution is financially responsible, despite its failure to meet standards based on the above measures, if that institution can meet certain other criteria, such as the posting of a letter of credit, demonstrating that it is not in danger of recipitous closure, or demonstrating that its liabilities are backed by the full faith and credit of a state or by an equivalent governmental entity;
- Require the annual submission of an audited and certified financial statement as a means of gathering information about financial responsibility and other requirements.

The statute also allows the Secretary, when necessary, and to the extent necessary to protect the financial interests of the United States, to require financial guarantees from institutions, and the assumption of personal liabilities on the part of persons who exercise substantial control over an institution.

Current regulations contain the following requirements:

- That institutions must meet general standards of financial responsibility, including the ability to provide contracted services, to provide necessary administrative resources, to meet all financial obligations with regard to debts, and to meet obligations with regard to federal funds, particularly refunds. The test for refund responsibility can be met in several different ways.

- That institutions must meet or exceed specific financial tests as indicated on an annual audited financial statement. Some, but not all, of these tests are differentiated among those that apply to for-profit institutions, those that apply to non-profit institutions, and those that apply to public institutions.
- That institutions must meet tests of past performance of an institution, or persons affiliated with the institution.
- That institutions, if they fail to meet particular criteria, must demonstrate financial responsibility according to an alternative method, including posting a letter of credit, demonstrating they are not in danger of precipitous closure, demonstrating they are backed by the full faith and credit of a state or equivalent government entity, or agreeing to be provisionally certified, in order to continue to be eligible to participate in title IV, HEA programs.

Improving Financial Responsibility Standards

The Department is continually evaluating the measures it uses to exercise its statutory oversight of the institutions participating in title IV, HEA programs. In this regard, the Department is interested in improving its oversight of such institutions, based on its experiences with the application of current tests and standards to financial statements. The HEA requires the annual submission of audited financial statements from all institutions that participate in any of the federal student financial assistance programs. Financial statements may be presented in any of several formats depending on the reporting entity's legal status and general purpose financial reporting requirements. Public institutions typically prepare financial statements conforming to the American Institute of Certified Public Accountants (AICPA) Audit Guide for Colleges and Universities, or a governmental accounting model described in Governmental Accounting Standard Board Statement 15. Private nonprofit institutions will follow an accounting model consistent with the Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards (SFAS) 116 and 117. Additionally, independent hospitals (i.e, medically-related institutions) report under a hospital model, while proprietary institutions, ranging in size and complexity from sole proprietorships to publicly traded multi-national corporations, each employ a financial reporting model consistent with the complexity of the reporting entity and in conformity with commercial Generally Accepted Accounting Principles (GAAP).

Currently the Secretary, at the direction of Congress, has established specific regulatory tests with respect to certain assets to liability ratios and net worth that measure an institution's financial capabilities. When applied uniformly across the universe of participating proprietary vocational schools, private non-profit colleges and universities, public colleges and universities, and profit and non-profit independent hospitals and health maintenance organizations, these tests provide generally reliable information about the financial health of the institutions examined. The Secretary, however, believes that the kind of information that the Department can extract from financial statements, and standards of financial responsibility based on that information, can be further improved. Such improvements would take into account both the total financial situation of the institution, and the different financial and operational characteristics that exist among commercial enterprises, municipalities, states, private nonprofit organizations and hospitals, each of which may be subject to fundamentally different accounting standards and financial reporting requirements.

For example, the Secretary now employs a limited type of ratio analysis as the principal means of assessing financial responsibility. Generally, these ratios address fundamental concepts such as liquidity, profitability and net worth. Current regulations require institutions to meet certain requirements for each one of these components separately. An institution that fails one test is deemed not financially responsible. In practice, however, the uniform application of independent sets of ratio measures across the universe of participating institutions reduces the reliability of the information gathered, because such an application does not always capture in a comparable fashion all relevant information about the fiscal responsibility of the respective institutions. Differences in accounting classifications and standards among different types of institutions exaggerate the perceived differences in financial strength of those institutions when they are measured under independent standards, even though those institutions may be identical with respect to fiscal responsibility when their total financial situation is taken into account. The current requirements therefore do not consider whether a weakness in one particular financial component is offset by financial strengths in the other components. For example, there may be instances in which an institution may fail a single measure or test (such as the acid test ratio) but could compensate for that failure by exhibiting strengths in other areas. Accordingly, the Secretary proposes to expand the scope of ratio analysis to take into account a greater range of financial data.

The Secretary also recognizes that the unique characteristics that distinguish the various business segments from one another are significant. As such, while it is appropriate to evaluate institutions within a given business segment by applying a general standard to that business segment, and it is also appropriate to evaluate the same elements of financial health across all business segments, it is difficult to establish comparable financial responsibility levels when applying a single standard across all business segments. The Secretary is committed to developing financial responsibility guidelines that take these differences into consideration. The Secretary is also committed to establishing fair and reasonable standards that measure the common, fundamental elements of financial health of all postsecondary institutions, such that standards developed according to sector-sensitive guidelines can be applied equitably across all sectors.

The KPMG Report

As part of its overall effort to improve its measures of financial responsibility, and as part of the Secretary's overall commitment to improve the quality, efficiency, and effectiveness of its oversight responsibility, the Department of Education commissioned in the Fall of 1995 the accounting firm of KPMG Peat Marwick, LLP to examine the current regulatory measures, and recommend improvements to those measures, especially in terms of taking into account the institution's business sector and total financial condition. The goal of the study was the development of processes, measures and standards the Secretary could use to better assess risk to federal funds through the analysis of financial statements and other documentation.

Over the past 20 years, KPMG has developed a methodology that uses ratios to measure key elements common across all business sectors. These ratios are constructed so that the individual numerators and denominators are defined in such a way that they can be easily drawn from the financial statements of institutions from different business segments. Drawing upon this methodology and on professional experience and literature in the field, KPMG conducted this study for the Department during the Fall of 1995 and Spring of 1996. As a result of the study, KPMG identified the most significant fundamental elements of financial health in postsecondary institutions—viability, profitability, liquidity, ability to borrow, and capital resources.

After consultation with a task force of individuals from the higher education community as well as other financial experts, and after conducting a reasonableness test of the proposed ratios by applying those ratios to a judgmental sample of institutional financial reports, KPMG recommended the following:

The Secretary adopt three ratios as the primary tests of financial responsibility. These ratios are the *Viability Ratio, Primary Reserve Ratio,* and the *Net Income Ratio.* The Viability Ratio is the ability of the institution to liquidate debt from its expendable resources. If the ratio is greater than 1 to 1, existing debt could be repaid from expendable resources available today. The Primary Reserve Ratio measures the ability to support current operations from expendable resources. This ratio provides a snapshot of financial strength and flexibility by comparing expendable resources to total expenditures or expenses, or operating size. This snapshot indicates how long the institution could operate using its expendable reserves without relying on additional net assets generated by operations. The Net Income Ratio measures the ability of an institution to live within its means in a given operating cycle. A positive Net Income Ratio indicates a surplus or profit for the year. Generally speaking, the larger the surplus or profit, the stronger the institution's financial position as a result of the year's operations. A negative ratio indicates a deficit or loss for the year.

The ratios scores be assigned strength factor values that take into account the differences between sectors, and that reflect the range of financial health. (The KPMG report refers to strength factor values as ''threshold values''). A strength factor value of (5) would indicate that, on the basis of that ratio alone, the institution is in exemplary financial health. A strength factor value of (1), on the other hand, indicates that the institution, based on that ratio alone, appears to be in immediate financial difficulty. The strength factor values for each ratio, broken down by sector, are contained in Appendix F of the proposed regulations (which will be codified with those regulations), and a more detailed explanation for these strength factor values is contained in the separate appendix to this Notice of Proposed Rulemaking that will not be codified in final regulations.

The strength factor scores for each institution be summed in accordance with a weighting mechanism that again takes into account the differences among business sectors to create a composite score. For example, public and private non-profit institutions would both have their Primary Reserve ratios weighted most heavily, while for proprietary institutions, the Net Income ratio would be weighted most heavily. This difference reflects the fact that privates and non-profits can and usually do retain expendable resources, while proprietaries can, but usually do not, retain expendable resources. The weighting values for each sector are contained in Appendix F of the proposed regulations, and a fuller explanation of those weightings is contained in the appendix to this Notice of Proposed Rulemaking.

The composite scores be divided into categories that reflect the overall financial position of the institution, which can be used by Departmental analysts to determine the level of risk represented by the institution. For purposes of this proposed rule, however, the only relevant score is that which marks the boundary between those institutions which, by regulation, are financially responsible by this test, and those that are not. As discussed below, the Department is proposing that the appropriate composite score be set at 1.75; i.e., those institutions that receive a composite score of 1.75 or higher would be considered financially responsible by this test (though they still must meet other tests, such as prior performance, in order to be deemed financially responsible), and those that receive a score of less than 1.75 would not be deemed financially responsible by this test. This standard is based on KPMG's conclusion that an institution that attains a composite score of less than 1.75 represents an immediate financial problem.

A more extensive discussion of KPMG's report is contained in the appendix to this Notice of Proposed Rulemaking. The entire report is also available for inspection during regular business hours at the address provided at the beginning of this preamble. The Secretary also invites comments on the KPMG report.

DEFINITIONS OF THE PROPOSED RATIOS

Viability Ratio

Public institutions following the 1973 AICPA audit guide [1]	Public institutions following a government model	Private non-profit hospitals and institutions	Proprietaries	For-profit hospitals
Expendable Fund Balances [2] ÷ Plant Debt	Gov't and Proprietary Fund Equity ÷ General Long-Term Debt	Expendable Net Assets [3] ÷ Long-Term Debt [4]	Adjusted Equity [5] ÷ Total Long-Term Debt	Expendable Fund Balances ÷ Long-Term Debt

[1] Public institutions have the option of preparing their statements according to the 1973 AICPA Guide for Colleges and Universities, or the governmental model.

[2] Expendable Fund Balances are computed as follows: General, specific purpose, and quasi-endowment fund balances—plant equity. True endowments are specifically excluded from the numerator.

[3] Expendable Net Assets are calculated as follows:
Unrestricted Net Assets.
Plus Temporarily Restricted Net Assets.
Minus Property, plant and equipment.
Minus Plant debt (including all notes, bonds, and leases payable to finance those fixed assets).
Equals Expendable Net Assets.

[4] Long-term debt is defined as all amounts borrowed for long-term purposes from third parties and includes: (1) Notes payable, (2) Bonds payable, and (3) Leases payable.

[5] Adjusted equity is computed as follows:
Total Owner(s) or Shareholders Equity.

Minus Intangible assets.
Minus Unsecured related party receivables.
Minus Property, plant and equipment (net of accumulated depreciation).
Plus Total long-term debt.
Equals Adjusted Equity.

If total long-term debt exceeds the value of net property, plant and equipment, then the asset is not subtracted from equity nor is the liability added back.

Primary Reserve Ratio

Publics using the 1973 AICPA audit guide	Publics using a governmental model	Private non-profit hospitals and institutions	Proprietaries	For-profit hospitals
Expendable Fund Balances ÷ Total Expenditures and Mandatory Transfers	Governmental and Proprietary Fund Equity ÷ Total Government Expenditures and other Financing Uses (Excluding Transfers) and Total Proprietary Expenses	Expendable Net Assets ÷ Total Expenses	Adjusted Equity ÷ Total Expenses	Expendable Fund Balances ÷ Total Expenses

Net Income Ratio

Publics using 1973 AICPA audit guide	Publics using a governmental model	Private non-profit hospitals and institutions	Proprietaries	For-profit hospitals
Net Total Revenues ÷ Total Revenues	Proprietary Income Before Operating Transfers, + Gov'tal Revenues and Other Financing Sources (exc. transfers)—Gov't Expenditures and Other Financing Uses (excluding transfers) ÷ Total Governmental and Proprietary Revenues and other Financing Sources (excluding transfers)	Change in Unrestricted Net Assets ÷ Total Unrestricted Income	Income Before Taxes ÷ Total Revenues	Revenue & Gains in Excess of Expenses & Losses (Net Total Revenues) ÷ Total Revenues

The Secretary's Use of the KPMG Report

The Secretary proposes adopting the methodology recommended in the KPMG report to replace the ratio methodology now contained in § 668.15. For the most part, the Secretary proposes this methodology without change in order to seek comment from the community on the merits of this approach. However, in its final report KPMG concluded that a composite score below 1.75 indicates an immediate financial problem, but acknowledged that the identification of a bright line standard for passing or failing the financial responsibility standards was a policy decision that should be made by the Secretary. The Secretary is therefore proposing to adopt the composite score standard of 1.75 as the bright line standard for the ratio test, and to equate a failure to demonstrate financial responsibility with the threshold that KPMG identified as posing a significant risk of immediate financial problems. The Secretary believes that including this methodology in the proposed regulations in this fashion will best utilize the KPMG study, and that any adjustments to the KPMG recommendations and the Secretary's designation of 1.75 as the cutoff score would best be made with the benefit of public comments.

In addition, the Secretary proposes in this NPRM a number of other changes to the financial responsibility regulations, and to the audit requirements contained in section 668.23. A summary of all these changes follows.

Summary of Proposed Changes

In proposing to move the financial responsibility regulations from § 668.15 to the new Subpart L of Part 668, the Secretary proposes that certain segments of the existing regulations be kept intact, and that significant changes be made in others. A part of these proposed changes is also a revision of § 668.23. A summary of the new locations of existing regulations, proposed changes to regulations, and issues on which the Secretary particularly invites comments follows below.

§ 668.23 Compliance Audits and Audited Financial Statements

In this section, the Secretary proposes to revise the provisions of the current § 668.23 and the audited financial statement requirements formerly located in § 668.15(e). The Secretary retains the requirement that an institution submit financial statements audited by an independent certified public accountant, and the provision for the submission of working and other papers on demand from the Secretary. However, the Secretary believes that it is possible to provide relief to institutions without compromising the ability of the Department to perform its oversight responsibilities. One way that this may be accomplished is to require institutions to submit a single audit, prepared on a fiscal year basis and audited under Generally Accepted Government Auditing Standards (GAGAS) and including the compliance information. A single compliance audit, prepared on a fiscal year basis rather than on an award year basis, would provide the basic information required by the Secretary for purposes of making a determination of financial responsibility. The Student Financial Assistance Audit Guide (*SFA Audit Guide*) now requires that all institutions submit audited financial statements as part of their compliance audits. For some institutions, particularly those in the proprietary sector, this has resulted in a requirement that institutions submit these two audited financial statements to the Secretary annually, but at two different times. These audits differ in at least two ways. One way in which they differ is that the financial statement required under the current § 668.15 is to be performed in accordance with Generally Accepted Auditing Standards (GAAS) and the financial statement that is required as part of the compliance audit is to be performed under GAGAS. Under the GAGAS standard, the auditor must go beyond GAAS standards to perform additional tests and express an opinion on the internal control structure and on compliance with all laws and title IV, HEA program regulations. The other difference is that the financial statement required under the current § 668.15 is to be conducted on a fiscal year basis, and the compliance audit is performed on an award year basis.

Thus the Secretary proposes to eliminate the submission of a separate financial statement four months after the end of the entity's fiscal year, as now required in § 668.15. Instead the Secretary proposes that the Department require institutions or third-party servicers to submit the A–128 or A–133 report in the timeframe provided by that guidance, or six months after the end of the institution's or servicer's fiscal year for entities that follow the *SFA Audit Guide,* as required in the proposed § 668.23. This compliance report would now include both the compliance audit and the audited financial statement, would be prepared on a fiscal year basis, and be prepared in accordance with GAGAS. It would be on the basis of the audited financial statement contained in the compliance report, as well as other documentation, that the Secretary would make determinations of financial responsibility by applying this proposed ratio test and other forms of analysis. As a result of this change, the compliance audit of an institution whose fiscal year does not coincide with an award year would cover parts of two award years. The Secretary recognizes that such a change may pose difficulties associated with providing a compliance audit spanning two different award years, but believes that the overall burden reduction for institutions from combining the two audits more than compensates for these difficulties.

The Secretary also proposes a modification of the treatment of the entity covered by the financial statement by clarifying the requirements that trigger the submission of consolidated statements. The Secretary proposes that an institution, as part of its audited financial statement, provide information regarding the institution's financial relationship with related entities, and that on request the institution must submit consolidated audited financial statements of the institution and related entities.

This proposed section contains audit submission requirements for foreign institutions, discussed below under the heading § 668.176 *Foreign Institutions.* The Secretary also proposes adding a paragraph regarding questionable accounting treatments. Under this proposal, if the Secretary questions an accounting treatment, the Secretary may submit the audit statements that contain those treatments to various bodies, including the AICPA, for review or resolution.

This proposed section contains requirements for a proprietary institution to disclose in a note to its financial statement the proportion of revenues it receives from title IV, HEA programs. This disclosure represents no added burden to the institution, since the auditor will have already prepared the information contained in the note to fulfill the requirements of § 600.5(d) and (e) within 90 days of the end of the institution's fiscal year.

This proposed section also includes the requirements regarding audit exceptions and repayments now contained in § 668.24. Section 668.24 is now being separately amended by the Secretary to include requirements regarding record retention.

Subpart L—Financial Responsibility

§ 668.171 Scope and Purpose

In this section the Secretary proposes to revise the scope and purpose statement currently in § 668.15(a) to more accurately reflect the purpose and intent of the law, to clarify the responsibilities of third-party servicers under this subpart, and to include a special transition rule discussed below.

§ 668.172 Financial Standards

This section incorporates the requirements currently in § 668.15(b)(1)–(5), and § 668.15(d) regarding financial obligations, refund standards and the alternatives to meeting the statutory refund reserve requirement, as well as the requirement that the institution must submit its compliance report by the date and in the manner prescribed in § 668.23 in order to be considered financially responsible.

The Secretary proposes in this section that a composite score of 1.75, calculated in accordance with § 668.173, be the minimum score an institution can achieve and still be determined financially responsible using the new ratio analysis.

The Secretary is proposing this composite score as a measure of financial responsibility because this score takes into consideration many important variables, with particular emphasis on expendable capital and profitability. A score of less than 1.75 suggests that the overall financial circumstance of the institution is such that one or more of the measured elements is at or below the minimum strength factor value and neither remaining measure is higher than the median strength factor value. Generally, this implies that the institution is having difficulty maintaining a marginal position with respect to financial health and, by at least one measure, it is failing to perform at even a minimal acceptable level. Conversely, marginal institutions that achieve a strength factor value indicating superior performance in any one of the measured elements are likely to achieve a composite score of 1.75 or more despite overall marginal performance. This is based on the assumption that superior performance in any one of the measured elements will, over time, lead to improvements in the other measured elements.

The use of a composite score encompasses the total financial circumstances of the institution examined. Each of the three principal measures attempts to identify a fundamental strength or weakness related to the institution's overall fiscal health. In particular, each factor isolates a critical aspect of fiscal responsibility and measures that element against an established benchmark. It is important to note, however, that no single measure is used. Rather, the measures are blended into a composite score that recognizes the basic differences that exist among the several types of institutions. By taking these differences into consideration, the Secretary is better able to make a determination as to overall institutional fiscal health. The differences among the institutions examined are recognized explicitly through the weighting methodology.

The use of a composite measure represents a departure from the Secretary's current approach to measuring fiscal responsibility. Currently, the Secretary applies similar measures, but individual compliance thresholds for each element are measured exclusively from one another, and not in combination. Under the current regulations, the Secretary implicitly recognizes the relationship among variables and established compliance thresholds for each element separately. The proposed regulations are similar in that poor performance in any one element may lead to a finding of non-compliance unless other measures are at least at the median performance level. What differs in relation to the current regulations is the recognition that superior performance in one or more fundamental elements of financial health adds a dimension to any analysis of fiscal responsibility that warrants consideration. Thus, with one exception discussed below, strength in one area may be considered to the extent that it offsets weakness in another. The Secretary believes that this better takes into consideration the total financial circumstances of an institution.

There is one proposed exception to the use of the composite score rather than individual ratios as the test of financial responsibility. Because KPMG recommended that a public or private non-profit institution that has a negative Primary Reserve Ratio be deemed an immediate financial problem despite its composite score, the Secretary proposes that in such circumstances the institution not be considered financially responsible under the ratio test. This adjustment is in recognition that a public or private non-profit institution that has a negative Primary Reserve Ratio is in such grave financial difficulty that even exemplary performance in other areas cannot cover for this deficiency.

The Secretary intends to publish on or by December 1, 1996 final regulations resulting from these proposed rules. Because the final regulations would become effective on July 1, 1997, the Secretary is proposing a special transition rule with regard to the implementation of the 1.75 composite score standard. The Secretary would allow an institution under proposed § 668.171(c) a one-year exemption from the new composite score standard if that institution passes the applicable ratio standard test now in place in § 668.15(b)(7)–(9). Thus an institution, for its fiscal year that began on or before June 30, 1997, that fails the 1.75 composite score standard but passes the appropriate ratio standard test contained in the current § 668.15, would still be considered financially responsible for one year. The Secretary believes it is appropriate to allow an institution to prove financial responsibility under the current standards based on the financial condition of the institution during the fiscal year that begins before these proposed rules become effective. Moreover, this one-time transition rule would give the institution at least 12 months to adjust its operations to meet the new standards.

In this section the Secretary also proposes a modification in the refund reserve requirement performance alternative. Section 498(c)(6) of the HEA requires that institutions maintain a cash reserve to pay required refunds. Current § 668.15(b)(5), and these proposed regulations, require institutions, unless they meet the provisions of specific exceptions, to provide the Secretary with a letter of credit equal to not less than 25% of the title IV, HEA program refunds for their previous fiscal year. One exception to this requirement is the provision for performance standards, in which the institution demonstrates that it has made required refunds, as attested to by the previous two years' compliance audits, and it has not had a finding of failure to make timely refunds. The Secretary wishes to address the issue of a finding of failure to make timely refunds. Without a standard under which such a finding is made, even one late refund may be interpreted as a failure to make timely refunds, and could trigger this requirement. While the Secretary expects all institutions to make all refunds in accordance with the regulations in § 668.22, and will enforce those regulations for every refund, the Secretary did not intend for isolated instances of late refunds to trigger the requirement for the provision of the letter of credit. Therefore, the Secretary is proposing that an institution would be eligible for the performance standard exception to the requirement to providing a 25% letter of credit, if (1) the independent CPA who audited the institution's financial statements and compliance audits, or the Secretary, a State or a guarantee agency that conducted a review of the institution, did not find that the institution made 5 percent or more of its refunds late, based on a sample of records audited and reviewed, and (2) the auditor did not note a material weakness or a reportable condition in the institution's report on internal controls that is related to refunds. The Secretary believes that these standards are reasonable and particularly requests comments on this proposal.

§ 668.173 Financial Ratios

This proposed section incorporates the methodology recommended by the KPMG study and contains the definitions of ratios by sector, and the procedure by which composite ratio scores are calculated. Specific strength factors for normalizing ratio scores and weighting the normalized ratios by sector are contained in the proposed Appendix F to Part 668. The Secretary proposes that these ratios and the resulting composite score replace the definition of ratios currently contained in § 668.15(b).

This proposed section also contains a definition of ''independent hospital'' for these purposes, and the accounting rules for calculating ratios previously in § 668.15(b) regarding the treatment of intangibles, extraordinary gains and losses, the income or losses from discontinued operations, cumulative effects of changes in accounting principles, prior period adjustments, and temporarily restricted assets.

The Secretary is particularly interested in comments regarding the definition and utility of these ratios. Are the terms used in defining them clear? Do the ratios themselves provide meaningful and useful information regarding the financial health of an institution? Are the ratios correctly constituted with relation to the different audit requirements of the various sectors of participating institutions? Are the weightings and strength factor levels appropriate for each sector? Will the composite scores give accurate pictures of financial health for all types of institutions? Will the composite scores give relevant and useful information regarding the financial health of institutions? Is the 1.75 composite score an appropriate bright line for determining the financial responsibility of an institution?

Also, the financial strength factors and weightings for hospitals currently reflect the situation of for-profit hospitals. The Secretary is interested in comments addressing the situation of non-profit hospitals, and whether the strength factors and weightings for those institutions should be different from those for for-profit hospitals.

§ 668.174 Alternate Standards and Requirements

The Secretary is proposing to modify and relocate the provisions permitting institutions to demonstrate financial responsibility under an alternative to the proposed composite score. All of the exceptions formerly located in § 668.15(d) are relocated to this section.

In this section the Secretary proposes to modify the method by which an institution demonstrates that it has sufficient assets to ensure against precipitous closure. The existing regulatory provisions implement the statutory exception in section 498(c)(3)(C) of the HEA that permits an institution otherwise failing prescribed ratios to demonstrate financial responsibility by showing that it has sufficient resources to ensure against its precipitous closure. Current regulations mirror certain statutory requirements that the institution demonstrate that it is meeting its financial obligations, and then require the institution to make specific demonstrations that it has not engaged in certain identified practices that could have caused the institution's deteriorated financial strength. The proposed regulations differ from this detailed analysis by establishing a lower threshold (represented by a composite score of 1.25) in order to qualify for this one-year exception, and then simply requiring the owners (or other persons who exercise substantial control over the institution) to assume personal liability for the institution's title IV obligations, rather than requiring a detailed analysis of the business dealings between the institution and its owners. The Secretary believes that this system will improve the administrative efficiency of implementing this exception and decrease the burden on the institutions using the exception by avoiding the detailed analysis of the business transactions between an institution and its owners. Furthermore, by establishing a separate minimum performance standard for institutions that seek to use this exception, the Secretary intends to ensure that more significant protections will be required for institutions whose financial condition has deteriorated during the preceding year to the point where the institution cannot meet those minimum thresholds. In such circumstances, these institutions must either use one of the other alternative means of demonstrating financial responsibility or be provisionally certified under the provisions for institutions that are not financially responsible.

With regard to financial standards and alternative standards for new institutions, the Secretary proposes that two alternatives enumerated in the statute—the provision of a letter of credit for at least 50% of the proposed title IV program funds that the Secretary determines the institution will receive during its initial year of participation, or proof that the institution is backed by the full faith and credit of a State or equivalent governmental entity—be utilized for new institutions. The requirement of meeting prior year standards precludes new institutions from availing themselves of the revised precipitous closure alternative. The Secretary believes this is warranted due to the greater uncertainty presented by institutions that have not established a track record of properly administering the title IV, HEA programs.

§ 668.175 Special Rules for an Institution That Undergoes a Change in Ownership

In this section the Secretary proposes to specify the requirements by which an institution that undergoes a change of ownership is deemed financially responsible, as well as establishing the audit submission requirements for applications for approval of changes of ownership.

The Secretary is proposing that entities applying for changes of ownership initially demonstrate financial responsibility in one of two ways. Either the new owners of the institution must submit personal financial guarantees, in an amount and form acceptable to the Secretary, or submit a letter of credit payable to the Secretary in an amount of not less than one half the amount of title IV, HEA program funds the Secretary determines the institution will receive during the year following the new ownership's opening day. A requirement for both these methods is that the institution submit a consolidated date of acquisition balance sheet for the institution as part of the institution's application for a change of ownership. The Secretary is also proposing that the personal guarantees or letter of credit remain in place until the institution submits audited financial statements that show that the institution meets the 1.75 composite score standard that is part of the general standards for demonstrating financial responsibility required of all participating institutions.

Historically, the Secretary has encountered difficulties in making comparable assessments of the financial resources for institutions seeking approval under new ownership. Sometimes the institution was sold because of an eroded or deteriorating financial condition. Without an opportunity to evaluate an audited financial statement that includes the operation of the newly acquired institution, the Secretary has had to make case-by-case examinations of the financial resources of the institution under its new ownership. Sometimes, this additional analysis has significantly delayed the approval of the applicant or such approval has been premised upon unaudited financial information that differed significantly from the audited financial statement that was later provided by the institution. The proposed regulations would streamline the approval process and provide greater protection to the taxpayers, while permitting the institution to participate and later demonstrate financial responsibility under the new proposed ratio analysis.

In addition, the Secretary is concerned that some entities seek multiple approvals for changes of ownership during one fiscal year, and this rapid growth increases the difficulty of assessing the financial resources that would be available to those institutions. The Secretary intends that such applicants will have to provide audited financial statements that incorporate all institutions for which they have already obtained approval to operate as part of the application for a new change of ownership. These proposed regulations therefore require the entity seeking the change of ownership to demonstrate that it has submitted audited financial statements to the Secretary that include all other institutions participating in title IV, HEA programs in which the entity has an ownership interest or over which it exercises substantial control, or to submit a current audited financial statement reflecting such operations and ownership interests. This means that for every change of ownership, the entity seeking the change in ownership would provide personal guarantees or a letter of credit until audited financial statements are submitted to the Secretary showing all the institutions that the entity owns or controls, including the institution or institutions that are the subject of the change of ownership application.

The Secretary is also considering requiring owners to post personal financial guarantees when institutions add additional locations, and these would remain in place until annual audits are submitted showing that the institution demonstrates financial responsibility under its expanded operations. The Secretary specifically invites comments on this proposal.

668.176 Foreign Institutions

In this section the Secretary proposes to clarify financial responsibility standards for foreign institutions. Under the proposed regulation, foreign institutions whose annual title IV participation is less than $500,000 per year will be permitted to submit their financial statement audits in accordance with the generally accepted accounting principles of each institution's home country. These audits will then be examined to determine financial responsibility. Foreign institutions whose annual title IV participation exceeds $500,000 per year will be required to have their financial statement audits translated as well as presented for analysis under U.S. GAAP and GAGAS, and would have to meet all regulatory requirements applicable to domestic institutions.

The Secretary is proposing this standard for foreign institutions to take into consideration several important distinguishing factors. First, foreign institutions are only eligible to participate in the student loan programs, and the relative size of such title IV funding at most institutions is relatively small when compared with their total financial operations. Second, foreign institutions with such relatively low volumes of title IV participation have not historically experienced compliance problems that appear to have resulted from impaired financial capability. Under the proposed regulations, these foreign institutions will provide annual financial statement audits and annual compliance audits that can be evaluated to determine whether an institution's operations are posing a risk to the taxpayers. The Secretary believes that the additional burden of translating the financial statement audits and presenting them under U.S. GAAP and GAGAS should only be imposed where significant amounts of title IV funds are expended at the foreign institution on an annual basis.

§ 668.177 Past Performance

This proposed section contains the requirements for past performance for an institution or persons affiliated with an institution that were formerly contained in § 668.15(c).

§ 668.178 Additional Requirements and Administrative Actions

This proposed section contains an outline of the administrative actions the Secretary takes when an institution fails any one of the various standards of financial responsibility, and specifies that failure to meet general standards of financial responsibility may subject institutions to the Limitation, Suspension, Termination, and Emergency Action provisions of Subpart G of Part 668. This proposed section also contains the portions of § 668.13(d) dealing with requirements and standards pertaining to provisional certification of institutions that are not financially responsible. The Secretary invites comments on whether the Department should include other types of requirements for institutions that are provisionally certified because they are not financially responsible, for example the development of teach-out plans.

With regard to this section, the following clarifies the consequences of not meeting the proposed 1.75 composite score standard (these consequences are also those that currently affect institutions that fail to meet one of the current ratio standards):

A certified institution whose financial statement is undergoing its annual review, or an institution that is undergoing recertification, would have the opportunity to meet one of the following alternate standards. If it had demonstrated financial responsibility in the previous year, it could prove that it is not in danger of precipitous closure by attaining a composite score of at least 1.25, and showing that it is current in its debt obligations, and if its owners or board of trustees submit personal financial guarantees and agree to be jointly and severally liable for any liabilities arising from the institution's participation in title IV, HEA programs. It could also submit to the Secretary an irrevocable letter of credit for at least 50% of the total title IV, HEA program funds the institution received during its latest fiscal year. A public institution would also have the opportunity to demonstrate that it is backed by the full faith and credit of a State or an equivalent government entity. An institution that meets any of these alternatives would be considered financially responsible. If an institution referred to above cannot or does not meet one of these alternatives, it may be offered provisional certification by the Secretary. In this case the institution would be required to submit to the Secretary an irrevocable letter of credit for at least 10% of the total title IV, HEA program funds the institution received during its latest fiscal year, demonstrate that it met all its financial obligations and was current on its debt payments for its two most recent fiscal years, and demonstrate that it is capable of participating under a funding arrangement other than the Department's advance funding method. An institution that participates under provisional certification in these circumstances is not considered to be financially responsible. If the institution is not offered provisional certification, or turns down provisional certification, the institution would then be subject to termination proceedings.

An institution seeking to participate for the first time in the title IV, HEA programs would have the opportunity to meet one of the following alternate standards. It could submit to the Secretary an irrevocable letter of credit for at least one-half of the amount of title IV, HEA program funds that the Secretary determines the institution will receive during its initial year of participation. A public institution would have the opportunity to demonstrate that it is backed by the full faith and credit of a State or an equivalent government entity. If the institution could not meet one of these alternative standards, it may be offered provisional certification, the terms of which are described above. If the institution is not offered provisional certification, or turns down provisional certification, it would not be eligible to participate in any title IV, HEA program.

Appendix F

This proposed appendix contains the strength factors and sector weightings for the new ratio analysis, an example of how composite scores are calculated, and a section for technical terms, all adopted from the KPMG report.

In enumerating the strength factors for institutions, the Secretary proposes following KPMG's adjustments by specifying that public and private non-profit institutions that have a negative Primary Reserve Ratio be deemed to fail the composite score test. The Secretary also proposes following KPMG's recommendation that for a proprietary institution that earns a (2) or (1) strength factor for its Primary Reserve Ratio, the strength factor for the Viability Ratio be no greater than the result of the Primary Reserve Ratio. The purpose of this adjustment is to prevent insignificant amounts of debt from significantly affecting the categorization of an institution.

Executive Order 12866

1. Assessment of Costs and Benefits

These proposed regulations have been reviewed in accordance with Executive Order 12866. Under the terms of the order the Secretary has assessed the potential costs and benefits of this regulatory action.

The potential costs associated with the proposed regulations are those resulting from statutory requirements and those determined by the Secretary to be necessary for administering this program effectively and efficiently. To the extent there are burdens specifically associated with information collection requirements, they are identified and explained elsewhere in this preamble under the heading *Paperwork Reduction Act of 1995.*

Thus, in assessing the potential costs and benefits—both quantitative and qualitative—of these proposed regulations, the Secretary has determined that the benefits of the proposed regulations justify the costs.

The Secretary has also determined that this regulatory action does not interfere unduly with State and local governments in the exercise of their governmental functions.

To assist the Department in complying with the specific requirements of Executive Order 12866, the Secretary invites comment on how to minimize potential costs or to increase potential benefits resulting from these proposed regulations consistent with the purposes of sections 487(c) and 498(c) of the HEA.

Summary of Potential Costs and Benefits

The Department has assessed the costs and benefits of the proposed regulations. This information is provided under the Initial Flexibility Analysis (below), and Summary of the KPMG Report Commissioned by the Department (appended to this NPRM).

2. Clarity of Regulations

Executive Order 12866 requires each agency to write regulations that are easy to understand.

The Secretary invites comments on how to make these regulations easier to understand, including answers to questions such as the following: (1) Are the requirements in the regulations clearly stated? (2) Do the regulations contain technical terms or other wording that interferes with their clarity? (3) Does the format of the regulations (grouping and order of sections, use of headings, paragraphing, etc.) aid or reduce their clarity? Would the regulations be easier to understand if they were divided into more (but shorter) sections? (A ''section'' is preceded by the symbol ''§'' and a numbered heading: For example, § 668.174 *Alternate standards and requirements*). (4) Is the description of the proposed regulations in the ''Supplementary Information'' section of the preamble helpful in understanding the proposed regulations? How could this description be more helpful in making the proposed regulations easier to understand? (5) What else could the Department do to make the regulations easier to understand?

A copy of any comments that concern how the Department could make these proposed regulations easier to understand should be sent to Mr. Stanley Cohen, Regulations Quality Officer, U.S. Department of Education, 600 Independence Avenue, S.W., Room 5121, FOB–10, Washington, D.C. 20202–2241.

3. Initial Flexibility Analysis

The Secretary has determined that a substantial number of small entities may experience significant economic impacts from this proposed regulation. In accordance with the Regulatory Flexibility Act (RFA), an Initial Flexibility Analysis (IRFA) of the adverse economic impact on small entities has been performed. A summary of the IRFA appears below.

Description of the Objectives of, and Legal Basis for, the Rule

The Secretary is directed by section 498(b) of the HEA to establish, on an annual basis, that institutions participating in title IV, HEA programs are financially responsible. As part of the Department's regulatory reinvention process, the Department has analyzed the current standards whereby institutions can demonstrate financial responsibility and found that improvements can be made. The proposed improvements are discussed at length in the preamble to this proposed rule.

Definition and Identification of Small Entities

The Secretary has adopted the U.S. Small Business Administration (SBA) Size Standards for this analysis. RFA directs that small entities are the sole focus of the Regulatory Flexibility Analysis. There are three types of small entities that are analyzed here. They are: for-profit entities with total annual revenue below $5,000,000; non-profit entities with total annual revenue below $5,000,000; and entities controlled by governmental entities with populations below 50,000. An estimate of the proportion of entities in each of these categories was calculated using the best available data, the National Center for Education Statistics IPEDS survey for the academic year 1993–1994. These estimates were applied to Department administrative files where no data element for total revenue is available. The estimates are that 1,690 small for-profit entities, 660 small non-profit entities and 140 small governmental entities will be covered by the proposed rule. Where exact data were not available to estimate the proportion of small entities, data elements were chosen that would have overestimated, rather than underestimated, the proportion. The Secretary particularly invites comments on the definition of small entity and the estimate of the number of small entities that would be covered by the proposed rule.

The component of the proposed rule that could potentially cause a small entity to be economically affected is the proposed modification of the tests for financial responsibility that are applied to the submitted financial statements. The proposed consolidation of the financial statement audit with the compliance audit that must be submitted to the Secretary would have a positive economic impact on all small (and large) entities. The proposed changes to one of the alternative methods of demonstrating financial responsibility would have a positive economic impact on those institutions that choose this alternative (otherwise it would not be chosen) and the Secretary believes that most institutions that would have been able to use the existing alternative method set out in the current regulations would be able to use the modified version. The costs of this alternative and the other existing alternatives are discussed below in the context of those institutions that experience adverse economic impacts.

Compliance Costs of the Proposed Rule for Small Governmental Entities

Small (and large) governmental entities that participate in the SFA programs have a statutory (section 498(c)(3)(B) of the HEA) alternative to the existing and proposed tests for demonstrating financial responsibility. This alternative allows for entities that are backed by the full faith and credit of a State to be considered financially responsible, and to be relieved of any costs of demonstrating financial responsibility. It is the Secretary's practice to identify financial statements from public institutions that appear to fail the numeric financial responsibility standards, and then to determine on a case by case basis whether that institution is backed by the full faith and credit of the state in which it is located. This alternative method of demonstrating financial responsibility is not changed under the proposed regulations, so the proposed rule will not have an increased significant economic impact on small governmental entities.

Compliance Costs of the Proposed Rule for Small For-profit and Small Non-profit Entities

Some small (and large) for-profit and non-profit entities will experience adverse economic impacts from this proposed rule, to the extent that they may fail the proposed standards (including the alternative measures for demonstrating financial responsibility) but would have been able to pass the current standards. Using the KPMG analysis described elsewhere, it was estimated that between 456 and 625 small for-profit entities and between 18 and 80 small non-profit entities would pass the existing test but fail the new proposed tests, and the Secretary seeks to minimize these adverse economic impacts by including in the regulations a provision that will treat an institution that passes the old standards as being financially responsible for any fiscal year that begins prior to the effective date of the final regulation. To the extent that some of these small entities will be unable to adjust their operations to come into compliance with the new standards beyond that transition period, the negative economic impact on these entities are those costs associated with employing the alternative methods for demonstrating financial responsibility. Costs for adjusting the operation of the institution to come into compliance may, in some cases, be significant, although more difficult to estimate.

The Secretary seeks comments on alternative ways of minimizing burden on small entities. One possible alternative for which the Secretary seeks comment is to delay the effective date of these rules for small entities.

To the extent that an institution that passed the current standards of financial responsibility could no longer do so without posting a surety, a rough estimate of the calculable costs of each of these alternative methods for a typical small entity was calculated. The typical small entity was proposed as one with $2,000,000 in total revenue, 84% of which comes from the SFA programs. It was not practicable to estimate the cost of obtaining external financing if the required capital was not readily available. This would depend on the risk profile of the particular entity and reliable estimates of this feature were not practicable. This rough estimate is that it could cost a typical small institution as much as $56,500 to secure a 50% letter of credit, although the actual costs to most institutions would be less if available credit lines or other assets could be pledged against the letter of credit. Similarly, if the institution were allowed to post a smaller surety in conjunction with provisional certification, the 10% letter of credit could cost as much as $20,500, or less depending on the other available resources that were used to secure the letter of credit. The Secretary notes that the relative cost of providing these letters of credit will correspond to the relative risk assessments made by the banks that provide the letters of credit to the institutions.

The amount it would cost a typical small entity to avail itself of the revised alternative standard for financial responsibility where the institution demonstrates that it has sufficient resources to ensure against its precipitous closure could not be reasonably estimated, but it is assumed that the costs would be smaller than those listed above for institutions that choose this method. These estimates are for the typical institution and the costs experienced by the actual institutions will undoubtedly be different. These estimates are provided to satisfy the RFA requirements that costs of compliance be described and should be used as illustrative examples only. The Secretary particularly invites comments on these estimates of each of these alternatives for small entities.

Discussion of Adverse Economic Impacts

This analysis has determined that between an estimated 456 and 625 small for-profit entities and between an estimated 18 and 80 small non-profit entities may not initially pass the proposed standards to demonstrate financial responsibility even though these institutions might have passed the current standards. This estimate was derived from information used in the KPMG study that had selectively included a number of schools that had a demonstrated lack of financial responsibility, so the projections in this analysis may overstate the expected number of institutions that are in this category. In order to ameliorate the effects of implementing a new standard for financial responsibility, the proposed regulations include a proposed alternative means to demonstrate financial responsibility under the current standards for fiscal years that began prior to the effective date of the proposed regulation. Institutions not able to come into compliance with the proposed standards following this transition period will experience adverse economic impacts from this proposed regulation, and the relative economic costs these institutions may face if they are required to post a letter of credit are discussed above. Since the proposed regulations provide a better measure of an institution's financial responsibility, the Secretary believes it is necessary to impose these additional costs on institutions that are unable to adjust their operations to meet these ratios, because failure to meet these ratios indicates a heightened risk to students and taxpayers.

The adverse economic impacts experienced by some small (and large) entities is balanced by the positive economic impacts experienced by some small (and large) entities. These positive impacts arise from the ability of the proposed tests to better judge financial responsibility. Between an estimated 138 and 369 small entities that failed the existing tests will pass the new tests because the proposed regulation determines financial responsibility by blending more financial information together into a composite score. These entities that have resources that were not adequately measured under the regulation will be spared the expense of pursuing alternative demonstrations of financial responsibility.

The negative economic impacts from this proposed regulation will only be felt by those additional entities that are judged to be not financially responsible by the proposed tests but may have been determined to be financially responsible under the current regulations. The Secretary believes that the proposed tests, developed by KPMG through extensive consultations with small (and large) entities, are better determinants of financial responsibility than the existing tests. The use of the proposed tests will enable the Secretary to better meet the responsibilities of section 498(c) of the HEA and to better safeguard the Federal fiscal interests and the interests of students.

Identification of Relevant Federal Rules Which May Duplicate, Overlap, or Conflict With the Proposed Rule

This rule reduces the number of audits which must be submitted to the Secretary by consolidating the financial statement audit with the compliance audit, removing some redundancy in these reporting requirements because financial information about the institution was being gathered separately through both of these submissions. The Secretary has not found any other Federal rules which duplicate, overlap, or conflict with the proposed rule. The Secretary particularly invites comments on other Federal rules which might meet these criteria.

Significant Alternatives That Would Satisfy the Same Legal and Policy Objectives While Minimizing the Economic Impact on Small Entities

The proposed changes to the financial responsibility regulations would satisfy the same legal and policy objectives that are addressed by the current regulations in a manner that the Secretary believes more accurately measures the financial strength of institutions participating in the title IV, HEA programs. This adoption of ratio analysis in conjunction with the revised alternative means for demonstrating financial responsibility will minimize the adverse economic impact on small (and large) entities that choose this alternative. Other alternatives, such as those that would establish differing compliance or reporting requirements or timetables based upon the size of the institution rather than the type of institution, or the use of performance standards rather than establishing baseline measures, or an exemption from coverage of the rule or any part thereof for small entities, would not adequately discharge the Secretary's obligation under section 498(c) of the HEA to determine the financial responsibility of participating institutions and guard the Federal fiscal interest. The Secretary has determined that there are no other significant alternatives that would satisfy the same legal and policy objectives while minimizing the economic impact on small entities. This determination is based, in part, on the extensive consultation that the Department and KPMG performed with small (and large) entities in developing these proposed revisions. The Secretary particularly invites comments on this determination.

Conclusion

The Secretary concludes that a number of small entities that are able to demonstrate financial responsibility under the current regulations may experience significant adverse economic impacts if they are unable to adjust their operations over time to meet the financial responsibility standards in the proposed rule. However, as discussed in the section referring to the cost-benefit assessment of the proposed rule pursuant to Executive Order 12866, the Secretary has concluded that the costs are outweighed by the benefits of putting in place a better system for measuring financial responsibility. In this case, the benefits are better protection of the Federal fiscal interest due to an improved numerical measure, and a transition to a system that will recognize some small entities as being financially responsible even though they would not pass the tests required under the current regulations.

The Secretary invites comments on any aspect of this analysis, particularly comments on the definition of small entity, the estimated number of institutions that are expected to experience adverse economic impacts, the estimated costs of alternative demonstration of financial responsibility, and any significant alternatives that would satisfy the same legal and policy objectives while minimizing the economic impact on small entities.

Paperwork Reduction Act of 1995

Sections 668.23 and 668.175 contain information collection requirements. As required by the Paperwork Reduction Act of 1995, the Department of Education has submitted a copy of these sections to the Office of Management and Budget (OMB) for its review.

Collection of Information: Financial Responsibility

These regulations affect the following types of entities eligible to participate in the title IV, HEA programs: Educational institutions that are public or nonprofit institutions, and businesses and other for-profit institutions. The information to be collected are audited financial statements, and, for institutions undergoing changes of ownership, consolidating date of acquisition balance sheets. Institutions of higher education that participate in title IV, HEA programs will need this information required by these regulations to meet the eligibility requirements for participation set forth in sections 487 and 498 of the HEA. Institutions must submit annually audited financial statements to the Secretary in accordance the time limits established in either the relevant OMB circular or the *SFA Audit Guide.* This annual submission, already required of institutions and already reflected in the burden hour inventory, will also serve for the separate submission of an annual audited financial statement currently required under § 668.15. For-profit institutions undergoing a change of ownership must also submit consolidating date of acquisition balance sheets with their application for approval of change of ownership. The Secretary needs and uses these audits and balance sheets (in the case of institutions undergoing a change of ownership) to analyze the financial situation of institutions and to determine whether particular institutions have sufficient financial strength to provide the educational services which they have contracted to provide, and to act as fiduciaries for federal student aid.

Information is to be collected, audited, and reported to the Secretary once each year for institutions and third-party servicers covered by § 668.23 and formerly covered by § 668.15. Annual public reporting and recordkeeping burden is estimated to average 1 hour for each response for 8,000 respondents for § 668.23. These hours include the time needed for searching existing data sources, and gathering, maintaining, and disclosing the data. Educational institutions that are public or nonprofit institutions or businesses or other for-profit institutions may participate in the title IV, HEA programs. Institutions of higher education that participate in title IV, HEA programs will need and use the information required by these regulations to meet the eligibility requirements for participation in programs contained in sections 487 and 498 of the HEA.

Because these proposed regulations would eliminate the separate financial statement submission in § 668.15 there is a reduction in recordkeeping burden of 1 hour per institution, or a total reduction of 10,000 burden hours for the elimination of § 668.15.

Information is to be collected and reported to the Secretary with applications for changes of ownership for institutions covered by §668.175. Annual public reporting and recordkeeping burden is estimated to average 0.25 hours for each response for an average of 200 responses annually for § 668.175. These hours include the time needed for searching existing data sources, and gathering, maintaining, and disclosing the data. Educational institutions that are businesses or other for-profit institutions will need and use the information required by these regulations to meet the eligibility requirements for participation in programs contained in section 498 of the HEA.

Organizations and individuals desiring to submit comments on the information collection requirements should direct them to the Office of Information and Regulatory Affairs, OMB, Room 10235, New Executive Office Building, Washington, DC 20503; Attention: Desk Officer for U.S. Department of Education.

The Department considers comments by the public on these proposed collections of information in—

- Evaluating whether the proposed collections of information are necessary for the proper performance of the functions of the Department, including whether the information will have practical use;
- Evaluating the accuracy of the Department's estimate of the burden of the collection of information are necessary for the proper performance of the functions of the Department, including whether the information will have practical use;
- Enhancing the quality, usefulness, and clarity of the information to be collected; and
- Minimizing the burden of the collection of information on those who are to respond, including the use of appropriate automated, electronic, mechanical, or other technological collection techniques, or other forms of information technology; e.g., permitting electronic submission of responses.

OMB is required to make a decision concerning the collection of information contained in these proposed regulations between 30 and 60 days after publication of this document in the

Federal Register. Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to the Department on the proposed regulations.

Invitation to Comment

Interested persons are invited to submit comments and recommendations regarding these proposed regulations.

All comments submitted in response to these proposed regulations will be available for public inspection, during and after the comment period, in Room 3045, Regional Office Building 3, 7th and D Streets S.W., Washington, D.C. between the hours of 8:30 a.m. and 4 p.m., Monday through Friday of each week except Federal Holidays. A copy of the KPMG report will also be available for inspection at this location.

List of Subjects in 34 CFR Part 668

Administrative practice and procedures, Colleges and universities, Reporting and Recordkeeping requirements, Student aid.

Dated: September 11, 1996.

Richard W. Riley,

Secretary of Education.

(Catalog of Federal Domestic Assistance Number: 84.007 Federal Supplemental Educational Opportunity Grant Program; 84.032 Federal Family Educational Loan Program; 84.032 Federal PLUS Program; 84.032 Federal Supplemental Loans for Students Program; 84.033 Federal Work-Study Program; 84.038 Federal Perkins Loan Program; 84.063 Federal Pell Grant Program; 84.069 Federal State Student Incentive Grant Program, and 84.268 Direct Loan Program)

The Secretary proposes to amend part 668 of title 34 of the Code of Federal Regulations as follows:

PART 668—STUDENT ASSISTANCE GENERAL PROVISIONS

1. The authority citation for part 668 continues to read as follows:

Authority: 20 U.S.C. 1085, 1088, 1091, 1092, 1094, 1099c and 1141, unless otherwise noted.

§ 668.13 [Amended]

2. Under § 668.13, paragraph (d) is being removed and paragraphs (e) and (f) are redesignated as paragraphs (d) and (e).

§ 668.15 [Removed and reserved]

3. Section 668.15 is removed and reserved.

4. Section 668.23 is revised to read as follows:

§ 668.23 Compliance audits and audited financial statements.

(a) *General*—(1) *Institutions.* An institution that participates in any title IV, HEA program must at least annually have an independent auditor conduct a compliance audit of its administration of that program. As part of that compliance audit the institution must also have an independent auditor conduct an audit of the institution's general purpose financial statement.

(2) *Third-party servicers.* Except as provided under this part or 34 CFR part 682, with regard to complying with the provisions under this section a third-party servicer must follow the procedures contained in the *SFA Audit Guide* for third-party servicers. A third-party servicer is defined under § 668.2 and 34 CFR 682.200. (The *SFA Audit Guide* is available from the Department of Education's Office of Inspector General.)

(3) *Submission deadline.* Except as provided by the Single Audit Act, Chapter 75 of title 31, United States Code, an institution must submit annually to the Secretary its compliance audit (including its audited financial statement) no later than six months after the last day of the institution's fiscal year.

(4) *Audit submission requirements.* In general, the Secretary considers the compliance audit submission requirements (including those of the audited financial statement) of this section to be satisfied by an audit conducted in accordance with the Office of Management and Budget Circular A–133, ''Audits of Institutions of Higher Education and Other Nonprofit Organizations''; Office of Management and Budget Circular A–128, ''Audits of State and Local Governments'', or the *SFA Audit Guide,* whichever is applicable to the entity. (Both circulars are available by calling OMB's Publication Office at (202) 395–7332, or they can be obtained in electronic form on the OMB Home Page at (http://www.whitehouse.gov).)

(b) *Compliance audits for institutions.* (1) An institution's compliance audit must cover, on a fiscal year basis, all title IV, HEA program transactions, and must cover all of those transactions that have occurred since the period covered by the institution's last compliance audit.

(2) The compliance portion of the audit required under this section must be conducted in accordance with—

(i) The general standards and the standards for compliance audits contained in the U.S. General Accounting Office's (GAO's) Government Auditing Standards. (This publication is available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402); and

(ii) Procedures for audits contained in audit guides developed by, and available from, the Department of Education's Office of Inspector General. (These audit guides do not impose any requirements beyond those imposed under applicable statutes and regulations and GAO's Government Auditing Standards.)

(3) The Secretary may require an institution to provide a copy of its compliance audit report to guaranty agencies or eligible lenders under the FFEL programs, State agencies, the Secretary of Veterans Affairs, or nationally recognized accrediting agencies.

(4) An institution that has a compliance audit conducted under this section must—

(i) Give the Secretary and the Inspector General access to records or other documents necessary to review the audit; and

(ii) Require an individual or firm conducting a compliance audit to give the Secretary and the Inspector General access to records, audit work papers, or other documents necessary to review the audit.

(5) An institution must give the Secretary and the Inspector General access to records or other documents necessary to review a third-party servicer's audit.

(c) *Compliance audits for third-party servicers.* (1) A third-party servicer that administers title IV, HEA programs for institutions does not have to have a compliance audit performed if—

(i) The servicer contracts with only one institution; and

(ii) The audit of that institution's administration of the title IV, HEA programs involves every aspect of the servicer's administration of that program for that institution.

(2) A third-party servicer that contracts with more than one participating institution may submit a single compliance audit report that covers the servicer's administration of the title IV, HEA programs for each institution with which the servicer contracts.

(3) A third-party servicer must submit annually to the Secretary its compliance audit no later than six months after the last day of the servicer's fiscal year.

(4) A third-party servicer must give the Secretary and the Inspector General access to records or other documents necessary to review an institution's compliance audit.

(5) The Secretary may require a third-party servicer to provide a copy of its audit report to guaranty agencies or eligible lenders under the FFEL programs, State agencies, the Secretary of Veterans Affairs, or nationally recognized accrediting agencies.

(6) A third-party servicer that has a compliance audit conducted under this section must—

(i) Give the Secretary and the Inspector General access to records or other documents necessary to review the audit; and

(ii) Require an individual or firm conducting an audit described in this section to give the Secretary and the Inspector General access to records, audit work papers, or other documents necessary to review the audit.

(d) *Audited financial statements*—(1) *General.* To enable the Secretary to make a determination of financial responsibility, as part of its compliance audit an institution must submit to the Secretary a set of financial statements for it latest complete fiscal year. These financial statements must be prepared on an accrual basis in accordance with generally accepted accounting principles, and audited by an independent certified public accountant in accordance with generally accepted government auditing standards and other guidance contained in the Office of Management and Budget Circular A–133, ''Audits of Institutions of Higher Education and Other Nonprofit Organizations''; Office of Management and Budget Circular A–128, ''Audits of State and Local Governments'', or the *SFA Audit Guide*, whichever is applicable. As part of these statements, the institution shall include a detailed description of related entities consistent with the definitions in SFAS 57, describing in detail the extent and nature of the related entity's interest, and the structure of the relationship between the institution and the related entity. The Secretary may also require the institution to submit or otherwise make available the accountant's work papers, and to submit additional substantive information.

(2) *Resolution of questionable accounting treatments.* In the event that the Secretary objects to accounting treatments contained in an institution's audited financial statements, the Secretary notifies the institution of the Secretary's concerns, and may refer those financial statements, along with other relevant documents, to the AICPA Committee on Accounting Standards, and other professional bodies and accounting experts for review or resolution.

(3) *Submission of additional financial statements.* (i) To determine whether an institution is financially responsible, the Secretary may also require the institution to submit the audited financial statements of related entities, consolidated financial statements, or full consolidating financial statements based upon the institution's economic relationship to those entities.

(ii) If the Secretary requires the submission of a related entity's financial statement, the Secretary may also require that the statement be supplemented with consolidating schedules showing the consolidation of each of the parent corporation's subsidiaries and divisions (each separate institution participating in the title IV, HEA programs shown separately) intercompany eliminating entries, and derived consolidated totals.

(4) *Audited financial statements for foreign institutions.* As part of an annual compliance audit, a foreign institution must submit—

(i) Audited financial statements conducted in accordance with the generally accepted accounting principles of the institution's home country, if the institution received less than $500,000 in title IV, HEA program funds during its most recently completed fiscal year; or

(ii) Audited financial statements translated to meet the requirements of paragraph (d) of this section, if the institution received $500,000 or more in title IV, HEA program funds during its most recently completed fiscal year.

(5) *Disclosure of title IV HEA program revenue.* A proprietary institution must disclose in a footnote to its financial statement the percentage of the title IV, HEA program revenue the institution received during that fiscal year, as calculated in accordance with § 600.5(d);

(6) *Audited financial statements for third party servicers.* A third-party 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, as provided under 34 CFR part 682, must submit annually an audited financial statement. This financial statement must be prepared on an accrual basis in accordance with generally accepted accounting principles, and audited by an independent certified public accountant in accordance with generally accepted government auditing standards and other guidance contained in the third party servicer audit guide issued by the Department of Education's Office of Inspector General.

(e) *Notification of questioned expenditures or compliance.* (1) As a result of a Federal audit or an audit performed at the direction of an institution or third-party servicer, if an expenditure made by the institution or servicer is questioned, or the institution's or servicer's compliance with an applicable requirement (including the lack of proper documentation) is questioned, the Secretary notifies the institution or servicer of the questioned expenditure or compliance.

(2) If the institution or servicer believes that the questioned expenditure or compliance was proper, the institution or servicer shall notify the Secretary in writing of the institution's or servicer's position and the reasons for that position.

(3) The institution's or servicer's response must be based on performing an attestation engagement in accordance with the Standards for Attestation Engagements of the American Institute of Certified Public Accountants and must be received by the Secretary within 45 days of the date of the Secretary's notification to the institution or servicer.

(f) *Determination of liabilities.* (1) Based on the audit finding and the institution's or third-party servicer's response, the Secretary determines the amount of liability, if any, owed by the institution or servicer and instructs the institution or servicer as to the manner of repayment.

(2) If the Secretary determines that a third-party servicer owes a liability for its administration of an institution's title IV, HEA programs, the servicer must notify each institution under whose contract the servicer owes a liability of that determination. The servicer must also notify every institution that contracts with the servicer for the same service that the Secretary determined that a liability was owed.

(g) *Repayments.* (1) An institution or third-party servicer that must repay funds under the procedures in this section shall repay those funds at the direction of the Secretary within 45 days of the date of the Secretary's notification, unless—

(i) The institution or servicer files an appeal under the procedures established in subpart H of this part; or

(ii) The Secretary permits a longer repayment period.

(2) Notwithstanding paragraphs (f) and (g)(1) of this section—

(i) If an institution or third-party servicer has posted surety or has provided a third-party guarantee and the Secretary questions expenditures or compliance with applicable requirements and identifies liabilities, then the Secretary may determine that deferring recourse to the surety or guarantee is not appropriate because—

(A) The need to provide relief to students or borrowers affected by the act or omission giving rise to the liability outweighs the importance of deferring collection action until completion of available appeal proceedings; or

(B) The terms of the surety or guarantee do not provide complete assurance that recourse to that protection will be fully available through the completion of available appeal proceedings; or

(ii) The Secretary may use administrative offset pursuant to 34 CFR part 30 to collect the funds owed under the procedures of this section.

(3) If, under the proceedings in subpart H, liabilities asserted in the Secretary's notification, under paragraph (e)(1) of this section, to the institution or third-party servicer are upheld, the institution or third-party servicer must repay those funds at the direction of the Secretary within 30 days of the final decision under subpart H of this part unless—

(i) The Secretary permits a longer repayment period; or

(ii) The Secretary determines that earlier collection action is appropriate pursuant to paragraph (g)(2) of this section.

(h) An institution is held responsible for any liability owed by the institution's third-party servicer for a violation incurred in servicing any aspect of that institution's participation in the title IV, HEA programs and remains responsible for that amount until that amount is repaid in full.

(Authority: 20 U.S.C. 1088, 1094, 1099c, 1141 and section 4 of Pub. L. 95–452, 92 Stat. 1101–1109)

5. A new Subpart L is added to read as follows:

Subpart L—Financial Responsibility

Sec.
668.171 Scope and purpose.
668.172 Financial standards.
668.173 Financial ratios.
668.174 Alternate standards and requirements.
668.175 Special rules for an institution that undergoes a change in ownership.
668.176 Foreign institutions.
668.177 Past performance.
668.178 Additional requirements and administrative actions.

Subpart L—Financial Responsibility

§ 668.171 Scope and purpose.

(a) *General.* To begin and to continue to participate in any title IV, HEA program, an institution must demonstrate to the Secretary that it is financially responsible under the standards established in this subpart. These standards are intended to ensure that a participating institution has the financial resources to—

(1) Deliver its education and training programs to students without interruption; and

(2) Meet its financial and administrative responsibilities to students and to the Secretary.

(b) *Third-party servicers.* (1) The general standards in this subpart apply to a third-party 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, as provided under 34 CFR part 682; and

(2) The provisions regarding past performance contained in § 668.177 apply to all third-party servicers.

(c) *Special transition-year rule.* (1) If an institution fails to satisfy the general standards under this subpart solely because it did not achieve a composite score of at least 1.75, as determined under § 668.173, the institution may demonstrate that it is financially responsible under the standards formerly codified under § 668.15 (b)(7) through (b)(9).

(2) An institution may demonstrate that it is financially responsible under the former standards only once, and only for the institution's fiscal year that began on or before June 30, 1997.

(Authority: 20 U.S.C. 1094 and 1099c and Section 4 of Pub. L. 95–452, 92 Stat. 1101–1109)

§ 668.172 Financial standards.

(a) *General standards.* In general, the Secretary considers an institution to be financially responsible if the Secretary determines that—

(1)(i) The institution's Viability, Primary Reserve, and Net Income ratios yield a composite score of at least 1.75, as calculated under § 668.173; and

(ii) For a public or private non-profit institution, that institution has a positive Primary Reserve ratio;

(2) The institution is meeting all of its financial obligations, including but not limited to—

(i) Refunds that it is required to make; and

(ii) Repayments to the Secretary for liabilities and debts incurred in programs administered by the Secretary;

(3) The institution is current in its debt payments. The institution is not current in its debt payments if—

(i) The institution is in violation of any existing loan agreement at its fiscal year end, as disclosed in a note to its audited financial statement; or

(ii) The institution 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; and

(4) In the institution's audited financial statements, the opinion expressed by the auditor was not an adverse opinion or disclaimed opinion, or the auditor did not express doubt about the continued existence of the institution as a going concern.

(b) *Refund standards.* (1) *Letter of credit.* In addition to satisfying the general standards, an institution must submit an irrevocable letter of credit, acceptable and payable to the Secretary, equal to 25 percent of the total amount of title IV, HEA program refunds paid by the institution during its most recently completed fiscal year, unless the institution qualifies for an exemption under this section.

(2) *Exemptions.* An institution is not required to submit the letter of credit described in paragraph (b)(1) of this section, if—

(i) The institution's liabilities are backed by the full faith and credit of the State, or by an equivalent government entity;

(ii) The institution is located in a State that has a tuition recovery fund approved by the Secretary and the institution contributes to that fund; or

(iii) The institution demonstrates that it made its title IV, HEA program refunds within the time permitted under § 668.22 during its two most recently completed fiscal years. The Secretary considers an institution to qualify for this exemption if the independent CPA who audited the institution's financial statements and compliance audits for either of those fiscal years, or the Secretary or a State or guaranty agency that conducted a review of the institution during those fiscal years—

(A) Did not find that the institution made 5 percent or more of its refunds late, based on the sample of records audited or reviewed; and

(B) Did not note a material weakness or a reportable condition in the institution's report on internal controls that is related to refunds.

(3) *Failure to make timely refunds.* (i) If the Secretary or a State or guaranty agency determines in a review conducted of the institution that the institution no longer qualifies for an exemption under this section, the institution must—

(A) Submit the irrevocable letter of credit to the Secretary no later than 30 days after the Secretary, or State or guaranty agency notifies the institution of that determination; and

(B) Notify the Secretary of the guaranty agency or State that conducted that review.

(ii) If an auditor determines in the institution's annual compliance audit that the institution no longer qualifies for an exemption under this section, the institution must submit the irrevocable letter of credit to the Secretary no later than 30 days after the date the institution's compliance audit must be submitted to the Secretary.

(4) *State tuition recovery funds.* In determining whether to approve a State's tuition recovery fund, the Secretary considers the extent to which that fund—

(i) Provides refunds to both in-State and out-of-State students;

(ii) Allocates all refunds in accordance with the order required under § 668.22; and

(iii) Provides a reliable mechanism for the State to replenish the fund should any claims arise that deplete the fund's assets.

(Authority: 20 U.S.C. 1094 and 1099c and Section 4 of Pub. L. 95–452, 92 Stat. 1101–1109)

§ 668.173 Financial ratios.

(a) *Composite score.* As detailed in Appendix F, the Secretary determines an institution's composite score by—

(1) Calculating the Viability, Primary Reserve, and Net Income ratios, as described in paragraph (b) of this section;

(2) Assigning a strength factor to each ratio that corresponds to the value of each of those ratios;

(3) Multiplying the assigned strength factor by the appropriate weighting percentage for each ratio; and

(4) Summing the resulting products of all three ratios.

(b) *Ratios.* (1) *Public institutions.* (i) As detailed in Appendix, F, the ratios for public institutions using the 1973 AICPA Audit Guide for Colleges and Universities are calculated as follows:

Viability ratio=Expendable Fund Balances÷Plant Debt

Primary Reserve ratio=Expendable Fund Balances÷Total Expenditures and Mandatory Transfers

Net Income ratio=Net Total Revenues÷Total Revenues

(ii) As detailed in Appendix F, the ratios for public institutions using a governmental accounting model are calculated as follows:

Viability Ratio=Governmental and Proprietary Fund Equity÷General Long-Term Debt

Primary Reserve Ratio=Governmental and Proprietary Fund Equity÷Total Governmental Expenditures and Other Financing Uses (excluding transfers) and Total Proprietary Expenses

Net Income Ratio=Proprietary Income Before Operating Transfers,+Governmental Revenues and Other Financing Sources (excluding transfers) − Governmental Expenditures and Other Financing Uses (excluding transfers)÷Total Governmental and Proprietary Revenues and Other Financing Sources (excluding transfers)

(2) *Private non-profit institutions.* As detailed in Appendix F, the ratios for private non-profit institutions are calculated as follows:

Viability ratio=Expendable Net Assets÷Long-term Debt

Primary Reserve ratio=Expendable Net Assets÷Total Expenses

Net Income ratio=Change in Unrestricted Net Assets÷Unrestricted Income

(3) *Proprietary institutions.* As detailed in Appendix F, the ratios for proprietary institutions are calculated as follows:

Viability ratio=Adjusted Equity÷Total Long-term Debt

Primary Reserve ratio=Adjusted Equity÷Total Expenses

Net Income ratio=Income Before Taxes÷Total Revenues

(4) *Independent hospitals.* (i) As detailed in Appendix F, the ratios for non-profit independent hospitals are calculated as follows:

Viability ratio=Expendable Net Assets÷Long-term Debt

Primary Reserve ratio=Expendable Net Assets÷Total Expenses

Net Income ratio=Change in Unrestricted Net Assets÷Unrestricted Income

(ii) As detailed in Appendix F, the ratios for for-profit independent hospitals are calculated as follows:

Viability ratio=Expendable Fund Balances÷Long-term Debt

Primary Reserve ratio=Expendable Fund Balances÷Total Expenses

Net Income ratio=Revenue & Gains in Excess of Expenses and Losses (Net Total Revenue)÷Total Revenues

(c) *Ratio values, strength factors and weighting percentages.* Appendix F contains—

(1) The ratio values and corresponding strength factors and weighting percentages for each type of institution under paragraph (b) of this section;

(2) Additional information regarding the calculation of certain ratios; and

(3) The conditions under which an adjustment may be made to the strength factors or weighting percentages in determining an institution's composite score.

(d) *Special definition.* For purposes of this subpart, an independent hospital is an institution that—

(1) Is not controlled by, or included in the financial statement of, another institution; and

(2) Prepares its financial statements under the accounting standards established in the AICPA's *audit guide for Audits of Health Care Organizations.*

(e) *Special rules for calculating ratios and determining financial responsibility.* For purposes of calculating the ratios defined in this section, and for purposes of determining whether an institution qualifies as financially responsible under an alternative method contained in this subpart, the Secretary—

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

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

(3) May exclude—

(i) Extraordinary gains or losses;

(ii) Income or losses from discontinued operations;

(iii) Prior period adjustment; and

(iv) The cumulative effect of changes in accounting principles.

(Authority: 20 U.S.C. 1094 and 1099c and Section 4 of Pub. L. 95–452, 92 Stat. 1101–1109)

§ 668.174 Alternate standards and requirements.

(a) *Alternatives for participating institutions.* A currently participating institution that fails to achieve a composite score of at least 1.75 may demonstrate to the Secretary that it is nevertheless financially responsible if—

(1) The institution's liabilities are backed by the full faith and credit of a State, or by an equivalent government entity;

(2) The institution submits an irrevocable letter of credit, that is acceptable and payable to the Secretary, for an amount equal to not less than one-half of the title IV, HEA program funds received by the institution during its most recently completed fiscal year; or

(3)(i) The owners, board of trustees, or other persons or entities who under § 668.177(c) exercise substantial control over the institution—

(A) Submit to the Secretary personal financial guarantees acceptable to the Secretary; and

(B) Agree to be jointly and severally liable for any liabilities that may arise from the institution's participation in the title IV, HEA programs.

(ii) The Secretary considers an institution to qualify under this alternative only if—

(A) The institution achieves a composite score of at least 1.25, based on its current fiscal year audited financial statements;

(B) The institution satisfied all of the general standards under § 668.172(a) in its previous fiscal year, based on that year's audited financial statements;

(C) The persons or entities providing financial guarantees submit to the Secretary their personal financial statements; and

(D) The institution convinces the Secretary that it will not close precipitously by demonstrating to the Secretary that it has sufficient resources to meet all of its financial obligations, including its obligations to students and to the Secretary, based on the institution's current fiscal year audited financial statements and the personal financial statements of the persons or entities providing personal financial guarantees.

(b) *Alternatives for new institutions.* If an institution seeking to participate for the first time in the title IV, HEA programs fails to satisfy any of the general standards, the institution may demonstrate that it is financially responsible if—

(1) The institution's liabilities are backed by the full faith and credit of a State, or by an equivalent government entity; or

(2) The institution submits an irrevocable letter of credit acceptable and payable to the Secretary, for at least one-half of the amount of title IV, HEA program funds that the Secretary determines the institution will receive during its initial year of participation.

(Authority: 20 U.S.C. 1094 and 1099c and Section 4 of Pub. L. 95–452, 92 Stat. 1101–1109)

§ 668.175 Special rules for an institution that undergoes a change in ownership.

(a) *General standards for financial responsibility.* The Secretary considers an institution that undergoes a change in ownership that results in a change of control, as described under 34 CFR 600.31, to be financially responsible only if the persons or entities that acquired an ownership interest in the institution, or that exercise substantial control over the institution, submit a consolidating date of acquisition balance sheet for the institution with their application for approval, and—

(1)(i) Submit to the Secretary personal financial guarantees from the owners, supported by personal financial statements, in an amount and form acceptable to the Secretary; or

(ii) Submit an irrevocable letter of credit acceptable and payable to the Secretary, for at least one-half of the amount of title IV, HEA program funds that the Secretary determines the institution will receive during the year following its date of acquisition.

(2) Personal financial guarantees or letters of credit submitted under this section will remain in place until the institution submits audited financial statements, prepared in the manner prescribed by § 668.23, showing that the institution attains a composite score of at least 1.75.

(b) *Audit requirements for changes of ownership applications.* An entity that seeks approval of a change in ownership—

(1) Must demonstrate that it has submitted to the Secretary an audited financial statement fulfilling the requirements of § 668.23 that includes all entities in which it holds an ownership interest, or over which it exercises substantial control; or

(2) Must submit a current audited financial statement acceptable to the Secretary that includes all entities in which it holds an ownership interest or over which it exercises substantial control, if the latest financial statement it submitted to the Secretary in fulfillment of the requirements of § 668.23 does not include, as of the date of the acquisition of the institution for which it seeks an approval of change of ownership, all entities in which it holds an ownership interest or over which it exercises substantial control .

(Authority: 20 U.S.C. 1094 and 1099c and Section 4 of Pub. L. 95–452, 92 Stat. 1101–1109)

§ 668.176 Foreign institutions.

The Secretary makes a determination of financial responsibility for a foreign institution on the basis of financial statements submitted under the following requirements—

(a) If the institution received less than $500,000 U.S. in title IV, HEA program funds during its most recently completed fiscal year, the institution must submit its audited financial statement for that year. For purposes of this paragraph, the audited financial statements may be prepared under the auditing standards and accounting principals used in the institution's home country; or

(b) If the institution received $500,000 U.S. or more in title IV, HEA program funds during its most recently completed fiscal year, the institution must submit its audited financial statement in accordance with the requirements of § 668.23, and satisfy the general standards or qualify under an alternate standard under this subpart.

(Authority: 20 U.S.C. 1094 and 1099c and Section 4 of Pub. L. 95–452, 92 Stat. 1101–1109)

§ 668.177 Past performance.

(a) *Past performance of an institution or persons affiliated with an institution.* The Secretary does not consider an institution to be financially responsible if—

(1) A person who exercises substantial control over the institution or any member or members of the person's family alone or together—

(i)(A) Exercises or exercised substantial control over another institution or a third-party servicer that owes a liability for a violation of a title IV, HEA program requirement; or

(B) Owes a liability for a violation of a title IV, HEA program requirement; and

(ii) That person, family member, institution, or servicer does not demonstrate that the liability is being repaid in accordance with an agreement with the Secretary; or

(2) The institution has been limited, suspended, terminated, or entered into a settlement agreement to resolve a limitation, suspension, or termination action initiated by the Secretary or a guaranty agency (as defined in 34 CFR part 682) within the preceding five years; or

(3) The institution had—

(i) An audit finding, during its two most recent compliance audits of its conduct of the title IV, HEA programs, that resulted in the institution's being required to repay an amount greater than five percent of the funds that the institution received under the title IV, HEA programs for any fiscal year covered by the audit;

(ii) A program review finding, during its two most recent program reviews of its conduct of the title IV, HEA programs, that resulted in the institution's being required to repay an amount greater than five percent of the funds that the institution received under the title IV, HEA programs for any year covered by the program review;

(iii) Been cited during the preceding five years for failure to submit acceptable audit reports required under this part, or individual title IV, HEA program regulations, in a timely fashion; or

(iv) Failed to resolve satisfactorily any compliance problems identified in program review or audit reports based upon a final decision of the Secretary issued pursuant to subpart G or subpart H of this part.

(b) *Correcting past performance.* The Secretary may determine an institution to be financially responsible even if the institution is not otherwise financially responsible under paragraph (a) of this section if—

(1) The institution notifies the Secretary, in accordance with 34 CFR 600.30, that the person referenced in paragraph (a)(1)(i) of this section exercises substantial control over the institution; and

(2)(i) The person repaid to the Secretary a portion of the applicable liability, and the portion repaid equals or exceeds the greater of—

(A) The total percentage of the ownership interest held in the institution or third-party servicer that owes the liability by that person or any member or members of that person's family, either alone or in combination with one another;

(B) The total percentage of the ownership interest held in the institution or servicer that owes the liability that the person or any member or members of the person's family, either alone or in combination with one another, represents or represented under a voting trust, power of attorney, proxy, or similar agreement; or

(C) Twenty-five percent of the applicable liability, if the person or any member of the person's family is or was a member of the board of directors, chief executive officer, or other executive officer of the institution or servicer that owes the liability, or of an entity holding at least a 25 percent ownership interest in the institution that owes the liability, and provided that the person or any member of the person's family did not hold more than a twenty-five percent ownership interest in the institution or servicer that owes the liability.

(ii) The applicable liability described in paragraph (a)(1) of this section is currently being repaid in accordance with a written agreement with the Secretary; or

(iii) The institution demonstrates why—

(A) The person who exercises substantial control over the institution should nevertheless be considered to lack that control; or

(B) The person who exercises substantial control over the institution and each member of that person's family nevertheless does not or did not exercise substantial control over the institution or servicer that owes the liability.

(c) *Ownership Interest.* (1) An ownership interest is a share of the legal or beneficial ownership or control of, or a right to share in the proceeds of the operation of, an institution, institution's parent corporation, a third party servicer, or a third party servicer's parent corporation. The term ''ownership interest'' includes, but is not limited to—

(i) An interest as tenant in common, joint tenant, or tenant by the entireties;

(ii) A partnership; and

(iii) An interest in a trust.

(2) The term ''ownership interest'' does not include any share of the ownership or control of, or any right to share in the proceeds of the operation of a profit-sharing plan, provided that all employees are covered by the plan.

(3) The Secretary generally considers a person to exercise substantial control over an institution or third party servicer, if the person—

(i) Directly or indirectly holds at least 20 percent ownership interest in the institution or servicer;

(ii) Holds together with other members of his or her family, at least a 20 percentownership interest in the institution or servicer;

(iii) Represents either alone or together with other persons, under a voting trust, power of attorney, proxy, or similar agreement one or more persons who hold, either individually or in combination with the other persons represented or the person representing them, at least a 20 percent ownership in the institution or servicer; or

(iv) Is a member of the board of directors, the chief executive officer, or other executive officer of—

(A) The institution or servicer; or

(B) An entity that holds at least a 20 percent ownership interest in the institution or servicer; and

(4) The Secretary considers a member of a person's family to be a parent, sibling, spouse, child, spouse's parent or sibling, or sibling's or child's spouse.

(Authority: 20 U.S.C. 1094 and 1099c and Section 4 of Pub. L. 95–452, 92 Stat. 1101–1109)

§ 668.178 Additional requirements and administrative actions.

(a) *Limitations, Suspensions, and Terminations.* The Secretary may initiate an action under subpart G of this part to limit, suspend, or terminate an institution's participation in the title IV, HEA programs if—

(1) The institution does not submit its audited financial statements by the date permitted and in the manner required under § 668.23; or

(2) The institution does not demonstrate that it is financially responsible under this subpart by satisfying the general standards or qualifying under an alternative standard, unless the Secretary permits the institution to participate under a provisional certification, as provided under § 668.13(c).

(b) *Participation of institutions that are not deemed financially responsible.* (1) The Secretary may permit an institution that is not financially responsible under paragraph (a)(2) of this section to participate under a provisional certification if—

(i) The institution submits to the Secretary an irrevocable letter of credit, that is acceptable and payable to the Secretary, for an amount equal not less than 10 percent of the title IV, HEA program funds received by the institution during its most recently completed fiscal year; and

(ii) If the institution demonstrates that it met all of its financial obligations and was current on its debt payments, as required under § 668.172(a)(2), for its two most recent fiscal years.

(2) The Secretary provides title IV, HEA program funds to an institution provisionally certified under this paragraph by reimbursement, as described under subpart K of this part, or under a funding arrangement other than the advance funding method.

(c) *Financial responsibility standards under provisional certification.* The Secretary may permit an institution described under paragraph (d) of this section to participate or to continue to participate under a provisional certification, only if the owners, board of trustees, or other persons or entities who under § 668.177(c) exercise substantial control over the institution—

(1) Submit to the Secretary their personal financial statements and personal financial guarantees for an amount acceptable to the Secretary;

(2) Agree to be jointly and severally liable for any liabilities that may arise from the institution's participation in the title IV, HEA programs; and

(3) Convince the Secretary that the institution will not close precipitously by demonstrating to the Secretary that it has sufficient resources to meet all of its financial obligations, including its obligations to students and to the Secretary, based on the institution's current fiscal year audited financial statements and the personal financial statements of the persons or entities providing personal financial guarantees.

(d) *Provisional certification for failure to meet financial responsibility standards.* The institution referred to under paragraph (c) of this section is an institution that—

(1) Is not financially responsible because of an adverse action taken by the Secretary, a material finding in prior audit or review, or because the institution failed to resolve satisfactorily

any compliance problems, as described under § 668.177(a) (2) and (3); or

(2) Is not currently financially responsible because it failed to satisfy all the general standards or qualify under an alternate standard under this subpart, and for this reason was certified provisionally at any time during the preceding 5 years.

(Authority: 20 U.S.C. 1094 and 1099c and Section 4 of Pub. L. 95–452, 92 Stat. 1101–1109)

5. A new Appendix F is added to part 668 to read as follows:

Appendix F—Financial Responsibility

This appendix contains the strength factors and weightings used to calculate composite ratio scores, the procedure for and an example of calculating a composite score, and technical definitions.

A. *Strength Factors:*

(1) PUBLIC INSTITUTIONS

Strength factor	1	2	3	4	5
Viability Ratio	<.50	.50–.99	1.0–1.99	2.0–3.99	≥4.0
Primary Reserve Ratio	<.10	.10–.19	.20–.44	.45–.69	≥.70
Net Income Ratio	<0	0–.009	.01–.029	.03–.049	≥.05

Additional Strength Factor Adjustment: If a public institution has a negative (less than zero) Primary Reserve Ratio result, the institution will be deemed as not financially responsible under the general standards contained in § 668.172(a).

(2) PRIVATE NON-PROFIT INSTITUTIONS THAT HAVE ADOPTED FASB STATEMENTS 116 AND 117

Strength factor	1	2	3	4	5
Viability Ratio	<.75	.75–1.74	1.75–2.74	2.75–4.74	≥4.75
Primary Reserve Ratio	<.30	.30–.49	.50–.99	1.00–1.49	≥1.5
Net Income Ratio	<0	0–.019	.02–.049	.05–.079	≥.08

Additional Strength Factor Adjustment: If a private non-profit institution has a negative (less than zero) Primary Reserve Ratio result, the institution will be deemed as not financially responsible under the general standards contained in § 668.172(a).

(3) PRIVATE NON-PROFIT INSTITUTIONS THAT HAVE NOT ADOPTED FASB STATEMENTS 116 AND 117

Strength factor	1	2	3	4	5
Viability Ratio	<.50	.50–.99	1.0–1.99	2.0–3.99	≥4.0
Primary Reserve Ratio	<.10	.10–.29	.30–.64	.65–.99	≥1.00
Net Income Ratio	<0	0–.009	.01–.029	.03–.049	≥.05

Additional Strength Factor Adjustment: If a private non-profit institution has a negative (less than zero) Primary Reserve Ratio result, the institution will be deemed as not financially responsible under the general standards contained in § 668.172(a)

(4) PROPRIETARY INSTITUTIONS

Strength factor	1	2	3	4	5
Viability Ratio	<.50	.50–.99	1.0–1.99	2.0–3.99	≥4.0
Primary Reserve Ratio	<.10	.10–.29	.30–.49	.50–.69	≥.70
Net Income Ratio	<.02	.02–.049	.05–.079	.08–.119	≥.12

Additional Strength Factor Adjustment: If a proprietary institution earns a strength factor of two (2) or one (1) for its Primary Reserve Ratio, the strength factor for the Viability Ratio will be no greater than the strength factor for its Primary Reserve Ratio. The purpose of this adjustment is to prevent insignificant amounts of debt from significantly affecting the categorization of an institution.

(5) INDEPENDENT HOSPITALS

Strength factor	1	2	3	4	5
Viability Ratio	<.50	.50–.99	1.0–1.99	2.0–3.99	≥4.0
Primary	<.10	.10–.29	.30–.64	.65–.99	≥1.00
Net Income	<0	0–.009	.01–.029	.03–.049	≥.05

B. *Weighting Factors:*

Institutions	Private non-profits (percent)	Public non-profits (percent)	Propri-etaries (percent)	Hospitals (percent)
Viability Ratio	35	35	30	40
Primary Reserve Ratio	55	55	20	20
Net Income Ratio	10	10	50	40
Totals	100	100	100	100

Additional Adjustments

Private and Public Non-Profits—If the institution has no debt, only the Primary Reserve and Net Income ratios are used, weighted 90% and 10% respectively.

Proprietaries—If the institution has no debt, only the Primary Reserve and Net Income ratios are used, weighted 50% each.

Hospitals: If the institution has no debt, only the Primary Reserve and Net Income ratios are used, weighted 60% and 40% respectively.

C. *Computing the Composite Score.*

Procedure

1. Calculate the Viability, Primary Reserve, and Net Income ratios.
2. Assign the appropriate strength factor to each ratio.
3. Multiply the assigned strength factors by the appropriate weighting percentage for each ratio.
4. Sum the resulting products of all three ratios to derive the composite score.

Example:

1. A public institution has the following ratio results:

Viability Ratio: Expendable Fund Balances ÷ Plant Debt = 0.60

Primary Reserve Ratio: Expendable Fund Balances ÷ Total Expenditures & Mandatory Transfers = 0.40

Net Income Ratio: Net Total Revenues÷Total Revenues = −0.008

2. These results are assigned a strength factor in accordance with the appropriate chart in part A of this appendix. Thus, for the public institution in this example:

A Viability Ratio of 0.60 corresponds to a strength factor of 2.

A Primary Reserve Ratio of 0.40 corresponds to a strength factor of 3.

A Net Income Ratio of –0.008 corresponds to a strength factor of 1.

3. The strength factors are then weighted in accordance with the chart in part B of this appendix. For the public institution in this example:

The Viability Ratio strength factor of 2 is weighted at 35%: 2×.35=0.70

The Primary Reserve Ratio strength factor of 3 is weighted at 55%: 3×.55=1.65

The Net Income Ratio strength factor is weighted at 10%: 1×.10=0.10

4. The weighted results are then summed:

Weighted Viability Ratio	.70
Weighted Primary Reserve Ratio	1.65
Weighted Net Income Ratio	+.10
Composite Score	2.45

D. Technical Definitions.

For Private Non-Profit Institutions

Expendable Net Assets are calculated as follows:

	Unrestricted Net Assets.
Plus	Temporarily Restricted Net Assets.
Minus	Property, plant and equipment.
Minus	Plant debt (including all notes, bonds, and leases payable to finance those fixed assets).
Equals	Expendable Net Assets.

For Proprietary Institutions

Adjusted Equity is computed as follows:

	Total Owner(s) or Shareholders Equity.
Minus	Intangible Assets.
Minus	Unsecured Related Party Receivables.
Minus	Property, Plant and Equipment (Net of Accumulated Depreciation).
Plus	Total Long-Term Debt.
Equals	Adjusted Equity.

If Total Long-Term Debt exceeds the value of Net Property, Plant and Equipment, then the asset is not subtracted from equity nor is the liability added back to equity

Total Long-Term Debt is comprised of all debt obtained for long-term purposes. The short-term portion of any long-term debt is included.

For Independent Hospitals

Expendable Net Assets are the general, specific purpose and quasi-endowment fund balances, less plant equity. True endowments are specifically excluded from the numerator.

Long-term Debt is notes payable, bonds payable, leases payable, and other long-term debt. Total Expenses are retrieved from the Statement of Revenue and Expenses of General Funds and is comprised of all expenses.

Appendix to the NPRM

Note: This appendix wll not appear in the Code of Federal Regulations.

Summary of the KPMG Report Commissioned by the Department

As part of its overall effort to improve its measures of financial responsibility, and as part of the Department's overall commitment to improve the quality, efficiency, and effectiveness of its oversight responsibility, the Department, in the Fall of 1995, commissioned the accounting firm of KPMG Peat Marwick, LLP to examine the current regulatory measures, and recommend improvements to those measures. KPMG was to assist the Department in developing an improved methodology, using financial ratios, that could be used as a screening device to identify financially troubled institutions and as a mechanism for efficiently exercising its financial oversight responsibility. For such a methodology to be effective, it would have to measure an institution's total financial condition, accommodate different organizational structures and missions of participating institutions, and reflect the different accounting and reporting requirements to which participating institutions are subject. The overall goal of the study was the development of processes, measures and standards the Department could use to better assess risk to federal funds through the analysis of financial statements and other documentation.

This study included the following elements:

- Analyses of existing financial reports using current standards, and using an alternative, expanded ratio analysis;
- The development of a new methodology that includes the use of an expanded set of specific ratios;
- The submission of that methodology to a task force and other outside reviewers for comment regarding the applicability of the ratios as measures, the definitions of the ratios, the treatment of particular accounting statements, the weighting of ratios in the construction of a composite score, and a ranking of composite scores that yields a category denoting institutions that would be considered, in the professional judgment of accountants, to be financial risks. More than a dozen reviewers participated, and included representatives from accounting firms, professional accounting associations, financial experts from the business community, officers of professional

education associations, and institutional financial officers and auditors.

• The subsequent refinement and retesting of the recommended methodology and standards, and the resubmission of that methodology and set of standards to the reviewers.

Problems of Reporting and Accounting Standards for Different Business Segments

One of the problems to be dealt with in the study was that of different reporting standards for different business segments. The financial responsibility regulations cover four segments in its regulation of participating institutions: public institutions, private non-profit institutions, proprietary institutions, and independent hospitals. The following summarizes differences in reporting standards.

Public institutions generally prepare financial statements in accordance with Statement No. 15 of the Governmental Accounting Standards Board.

Private non-profit institutions historically have prepared their financial statements consistent with the 1973 AICPA Audit Guide for Colleges and Universities. Those financial statements were similar, in most respects, to those prepared by public institutions. However, in 1993 the Financial Accounting Standards Board (FASB) issued two statements, Statement of Financial Accounting Standards (SFAS) No. 116, *Accounting for Contributions Received and Contributions Made*, and SFAS No. 117, *Financial Statements of Non-for-Profit Organizations*, that significantly redefined financial accounting and reporting for private non-profit institutions. As a result, these institutions are currently in a state of transition in complying with these new standards. Most private non-profit institutions are required to adopt these new standards during their 1996 fiscal year.

Proprietary institutions prepare their financial statements in accordance with accounting standards promulgated by FASB and the AICPA.

Independent hospitals prepare their financial statements by following guidelines set forth by the AICPA Audit Guide, Providers of Health Care Services. Similar to private non-profit institutions, many hospitals will also be subject to FASB Statements 116 and 117, but the financial statements of these institutions will not be as dramatically affected.

Also problematic are differences in GAAP among different business segments. Institutions of higher education have followed different accounting models for many years. For-profit institutions prepare their financial statements with GAAP applicable to commercial entities promulgated by FASB. Non-profit entities and public entities have generally used fund accounting models promulgated by industry groups and the AICPA. There have been obvious differences over the years, such as non-profits and publics not recording depreciation, nor being required to present a cash flow statement like their for-profit counterparts. To date, the financial statements of both public and private non-profit institutions have remained similar in most respects. However, recent actions by the FASB and GASB (primarily the issuance of FASB Statements 116 and 117) have substantially increased the differences in accounting and financial reporting between public and private non-profit institutions.

Some of the resulting differences in these various reporting and accounting standards are as follows. Under FASB Statements 116 and 117, three basic financial statements—a statement of financial position, a statement of activities, and a cash flow statement—are required for private non-profit institutions. These statements are prepared on an accrual basis and measure economic resources and changes therein. Prepared as they are on a highly aggregated basis, these statements include certain required minimum information. Generally, matters of format are left to the discretion of the institution. Public institutions, on the other hand, will for the foreseeable future prepare the statements called for by the 1973 AICPA Guide—a statement of financial position, a statement of changes in fund balances, and a statement of current funds revenue, expenditures, and other changes. (A limited number of institutions may also report financial results using the government reporting model—an option allowed under GASB Statement 15). These statements under the 1973 AICPA Guide are prepared on a highly desegregated basis and follow the traditional managed funds structure. As such, they include changes in fund balances arising from expenditures and disposals of fixed assets rather than any capital usage charge such as historical cost depreciation. The format of each statement must generally conform to the example financial statements in the AICPA Guide, which are considered by GASB Statement 15 to be prescriptive rather than illustrative.

Thus, with each statement issued under FASB and GASB standards, there are differences between the accounting and reporting requirements for institutions that affect the information the Department uses to assess financial responsibility. The most significant differences have arisen in the following areas: (1) Consolidation/reporting entity; (2) Recording of contributions; (3) Accounting for pension and postretirement benefits, and (4) Recording of depreciation. KPMG took these different reporting standards into account when recommending a methodology.

Problems of Exclusive Tests

Another problem KPMG was to examine was that of exclusive tests. The current regulations measure and establish minimum acceptable standards for liquidity, net worth, and profitability. Each is measured separately and the results are considered independently. For example, the liquidity standard for a for-profit institution is an acid test with a minimum acceptable result of 1:1. If the acid test (or any of the other ratio tests) is not met, the institution may not be considered financially responsible. In such situations, the institution would be required to demonstrate financial responsibility by another method even if it had exhibited strengths in other tests.

This problem is further complicated by the accounting and reporting differences across the business sectors, as described above. The current ratio tests and basic thresholds for non-profit and for-profit institutions are common, leading to gaps in necessary information where certain information necessary to evaluate an item is not required under that entity's general reporting format. One example is the use of the same acid test requirement of 1:1 for non-profit and for profit institutions. GAAP does not require non-profit institutions to prepare financial statements that classify assets and liabilities as current and noncurrent. Therefore, calculation of the acid test cannot be accurately performed without additional information. Moreover, differing cash management and investment strategies (investing excess cash in other than short-term instruments) may result in an institution failing the acid test requirement, when sufficient expendable resources are available in unrestricted investments to support operations for more than one year without any additional revenue.

Proposed Solution

KPMG proposed a ratio methodology that, similar to the current regulations, takes into account liquidity, profitability, and viability, but attempts to improve on the current regulations in three ways. First, it would consider all ratio results together, instead of as independent tests. The calculation of a composite score that blends the results of the individual tests would allow the Department to form a conclusion about the institution's total financial condition, instead of three separate conclusions concerning liquidity, profitability, and net worth. Second, the proposed methodology would establish a range of results for each ratio in contrast to the one minimum standard embodied in the current regulations. This range would assist the Department in allocating resources toward financially risky institutions. Finally, the proposed methodology takes into consideration the accounting and reporting differences of the different business segments by establishing different ratio definitions and strength factors for the same element of financial health (e.g., viability) for each business segment.

Methodology

KPMG introduced its first edition of *Ratio Analysis in Higher Education* in the 1970's to use as a tool to better understand and interpret an institution's financial situation. Today many industries, rating agencies and investors, and accrediting bodies use key ratios from GAAP financial statements to compare similar institutions' basic financial performance. In particular, KPMG and others developed this analysis to help them answer three fundamental questions with regard to the financial condition of institutions of postsecondary education:

• Is the reporting institution clearly financially healthy or not as of the reporting date?

• Is the reporting institution financially better off or not at the end than it was at the beginning of the year reported on?

• Did the reporting institution live within its means during the year being reported on?

While these questions were originally posed as a way of better informing such responsible parties as institutional administrators and trustees of the financial condition of the institution, they also serve the same purpose for the Department in its statutory responsibility to assess the financial health of a participating institution. Like administrators and trustees, the Department has a vital interest in assessing whether or not an institution can survive financially into the near future.

Ratio analysis provides answers to these questions by comparing sets of relevant numbers from the institution's financial report. Conceptually, this comparison describes the status, sources, and uses of an institution's financial resources in relation to its liabilities in such a way as to quantify the institution's relative ability to repay current and future debt and other obligations. Ratio analysis assumes that this comparison is necessary based on the fact that when considered in isolation, or as compared with absolute dollar standards, the dollar amounts representing assets and liabilities included in financial statements are not always meaningful measures of financial health. For example, the burden of debt and liabilities for an institution of any one size and operation and having access to a particular amount of resources will be different from another institution of a different size and operation and with access to a different amount of resources. Thus to provide an accurate measure of financial health, dollar amounts taken from an institution's financial statement should be analyzed in context of the institution's size, operations, and resources.

In turn, using ratios in tandem with one another depicts the institution in its financial totality. When the results of the application of a series of ratios are assigned to strength factors, weighted in accordance to sector, and then summed, the composite score that results provides an overall measure of financial responsibility. It is this overall measure, in the form of a composite score, that allows an investigator using professional judgement to determine the risk associated with the financial structure of the institution, and to develop a relative scale to compare institutions, and thus judge the magnitude of the risk, by comparing the institution's current position with similarly placed, comparable institutions. This approach avoids the possibility that failure to pass one test in isolation will automatically result in the conclusion that an institution is not financially responsible.

KPMG initially proposed the application of nine ratios to a random sample of the Department's financial reports as the empirical vehicle upon which to test the usefulness of ratio analysis as a gatekeeping tool, and to check the results of the application for reasonableness. Comments from reviewers at this point led KPMG to modify this research agenda. While all respondents believed that the overall approach was generally acceptable, some commenters recommended that KPMG revise its sampling approach to include a selection of financial reports from institutions that have failed financially, or are known to be in perilous financial health, in order to check that the measures not only accurately mark financial health, but also financial distress. It was believed that using as a test a random sample of only those institutions that are still continuing to participate in title IV, HEA programs without the check provided by the assured presence of distressed or closed schools in the sample, would lead to indicators that could not provide sufficient information for analysts to identify the point at which the risk of closure is so great that the Department would determine that the institution was not financially responsible. KPMG responded by constructing a judgmental sample that included institutions selected by reference to sector and financial history.

A summary of this sample is as follows. KPMG selected a purely random sample of public institutions. For private non-profit institutions, KPMG selected a group of institutions that included large research institutions, large and small liberal arts schools, institutions with going concern statements on their most recently audited financial statements, and some other randomly selected institutions. KPMG also randomly selected a group of private non-profit institutions that have adopted FASB statements 116 and 117. For proprietary institutions, KPMG selected institutions that passed and institutions that failed the standards set forth by the Accrediting Commission of Career Schools and Colleges of Technology. KPMG also selected proprietary institutions that were on the Department's list of institutions subject to surety requirements. KPMG then randomly selected some additional proprietary institutions. For the hospital sector, KPMG randomly selected a group of institutions.

Accordingly, KPMG applied nine ratios—Viability, Primary Reserve, Net Income, Liquidity, Leverage, Debt Burden, Debt Coverage, Secondary Reserve, and Plant Equity—to the financial reports of the institutions in this sample.

Results: Ratios

The first result was a confirmation of some of the reviewers' initial comments. Some respondents had expressed the belief that, for practical purposes, a total of nine ratios was excessive for an initial analysis. The process of applying the ratios to the financial reports confirmed that use of all nine ratios provided additional detail as to the source of financial problems, but added little value for purposes of differentiating clearly financially healthy institutions from the group of institutions whose financial health is uncertain. In light of the reviewers' comments and these results, KPMG reexamined the range and scope of ratios needed as an initial test of financial health, and determined that three—Viability, Primary Reserve, and Net Income would be sufficient to identify institutions that are of immediate financial concern.

KPMG conceptualizes these ratios as follows:

- Viability Ratio: the ability of the institution to liquidate debt from its expendable resources. If the ratio is greater than 1 to 1, existing debt could be repaid from expendable resources available today.

In the short term, substantial amounts of expendable capital, as measured by the Viability Ratio (and Primary Reserve Ratio, as discussed below) can counter the effects of poor profitability, liquidity, or an inability to borrow. Likewise, insufficient expendable capital is a clear warning sign of poor financial health. While a ratio of 1:1 or greater indicates that an institution is clearly healthy, no absolute strength factor is likely to indicate whether an institution is no longer financially viable. Most debt relating to plant assets is long term and does not have to be paid off at once. Yet it is clear that the lower the institution's viability ratio is below 1:1, the more likely that an institution must live with no margin for error and meet severe cash flow needs by obtaining short-term loans. Ultimately, such a financial condition will impair the ability of an institution to fulfill its mission and meet its service obligations to students. An institution that is continually experiencing a perilous financial situation will usually find itself driven primarily by financial rather than programmatic decisions.

- Primary Reserve Ratio: measures the ability to support current operations from expendable resources.

This ratio provides a snapshot of financial strength and flexibility by comparing expendable resources to total expenditures or expenses, or operating size. This snapshot indicates how long the institution could operate using its expendable reserves without relying on additional net assets generated by operations. A ratio of 1:1 or greater would indicate that an institution could operate for one year without any additional revenue being generated. A ratio of .5 to 1 (reserves necessary to operate for 6 months) would probably give an institution the flexibility needed to transform itself by means of a capital expansion, or a change in mission. A negative or decreasing trend over time indicates a weakening financial condition.

- Net Income Ratio: measures the ability of an institution to live within its means in a given operating cycle.

A positive Net Income Ratio indicates a surplus or profit for the year. Generally speaking, the larger the surplus or profit, the stronger the institution's financial position as a result of the year's operations. A negative ratio indicates a deficit or loss for the year. Small deficits may not be significant if the institution has large expendable capital. However, continued or large deficits or losses are usually a warning sign that major program or operational adjustments should be made. Because of its direct effect on viability, this ratio is one of the primary indicators of the underlying causes of a change in an institution's financial condition.

Strength Factors

In assigning the strength factors (called ''threshold factors'' in the KPMG report) for each applicable ratio, KPMG posed the question: What is the minimum result for each ratio that would indicate acceptable financial health? The answer to that question established the lower end of the neutral or mid range for which a strength factor of three (3) would be assigned. For example, KPMG's experience with for private colleges and universities indicates that a Primary Reserve Ratio of less than .30 indicates a less than healthy financial position. This conclusion is consistent with standard bond rating practices. Hence in order to receive a strength factor of (3) in its Primary Reserve Ratio, the result for a private college or university must be at least .30.

To establish the upper strength factor of five (5), the risk associated with the Department's overall objective of separating financially responsible institutions from those that appear financially unhealthy had to be considered. Assigning the highest strength factor to a ratio correlates to a very good financial condition. The process of assessing that institution for financial responsibility may be shortened. If the financial condition of such an institution were to be subsequently affected, the Department and students could suffer unanticipated financial losses. Accordingly, the range for such a rating should be high enough to minimize that risk. The nature of each ratio and what it represents also had to be considered. A Primary Reserve Ratio result of 1.00 or more indicates that the institution can continue to operate at its present level for at least one year without any additional revenue. If analysis were limited to the Primary Reserve Ratio, one would have to conclude that such an institution is in a strong financial position.

The minimum strength factors were established to clearly reflect financial problems. For example, a negative Net Income Ratio result for an institution demonstrates that during its fiscal year, the institution spent more than it received. Such activity will eventually create a financial problem. Accordingly, a negative Net Income ratio would be assigned a strength factor of one (1).

The recommended strength factors described in the proposed Appendix F have been customized for each sector. A discussion of the strength factors for each ratio follows.

Viability Ratio: (Expendable Net Assets ÷ Long-Term Debt) Because a ratio of 1:1 or greater indicates that, as of the balance sheet date, an institution is clearly healthy because it has sufficient expendable resources to satisfy debt obligations, the lower end of middle category (3) is a 1:1 ratio. The lowest category (1) is established at .5:1 and below. The highest categories (4 and 5) were established as greater than 2:1 and 4:1, respectively.

The same strength factors will be used for all sectors except for private non-profit institutions that have adopted the new accounting standards FASB Statements 116 and 117. A comparison of data from private non-profit institutions under the fund accounting model and those under the FASB Statements 116 and 117 model indicate that these strength factors should be approximately 30%–50% higher, because under the FASB model realized and unrealized endowment gains are generally classified as expendable funds.

Primary Reserve Ratio: (Expendable Net Assets ÷ Total Expenses) This ratio measures financial strength by comparing expendable resources to operating size (total expenditures or expenses). It is reasonable to expect that in a healthy institution, expendable resources would increase at least in proportion to the rates of growth of operating size. If they do not, the same dollar amount of expendable resources will provide a smaller margin of protection against adversity as the institution grows.

KPMG's experience and empirical testing indicate that a ratio of .3:1 or better indicates a financially healthy institution, and therefore the lower end of the middle strength factor of (3) is set as a ratio of .3:1. The lowest strength factor of (1) was established at .1:1 and below because having little more than one month or even negative expendable reserves indicates a financially risky institution. The strength factor (5) was established as greater than 1:1 because of the institution's ability to operate one year on existing reserves without an additional dollar of revenue.

Because operating and institutional differences exist among the different sectors of participating institutions, strength factors were modified for some business segments. Under the GASB reporting model, certain related entities and assets are not required to be reflected in the general purpose financial statements. In addition, many states will not allow significant unrestricted expendable reserves to build up in public institutions. It was also noted that published bond rating averages for public institutions rated Aa and A were 30–50% lower than private institutions rated Aa and A. Based on these factors and input from industry task force members, the strength factors for public institutions categories (2) through (5) were lowered by approximately 30%. A strength factor of (1) for public institutions remains at .1:1 because certain minimum reserves are necessary and .1:1 would still indicate an institution that is financially at risk.

With regard to proprietary institutions, owners of such institutions invest capital with the ultimate intent of returning that capital at a profit. Non-profit organizations, on the other hand, are generally precluded from distributing capital to contributors. It follows therefore that less capital will generally be left in proprietary institutions than in non-profit institutions. Therefore, the strength factor of (4) for this ratio has been lowered to .5 or greater, and strength factor (5) has been adjusted to .7 or greater. Furthermore, while a non-profit's Primary Reserve strength factor is automatically (1) if that result is less than zero, this adjustment is not made for proprietary institutions. The absence of this adjustment for the proprietary sector is in recognition of the fact that prudent business decisions may require an institution to have a negative capital balance for brief periods of time.

The strength factor factors for private institutions adopting FASB Statements 116 and 117 have been increased by 66% over private institutions using the fund accounting model. The inclusion of realized and unrealized gains on investments held as endowments in unrestricted and temporarily restricted net assets for the FASB model should lead to higher strength factors than those used to evaluate institutions following the AICPA Audit Guide financial reporting model where such gains are treated as nonexpendable.

Net Income Ratio: (Change in Unrestricted Net Assets ÷ Total Unrestricted Income) In the non-profit sectors (including public and private institutions and hospitals), this ratio measures whether institutions operate within their means. In the public sector, institutions are not necessarily encouraged to be ''profitable'', and in fact legislation may prohibit them from operating at anything other than a break-even level. In the for-profit sector, however, the capacity to generate operating funds through income is an important indicator of financial health.

Private and public non-profit institutions which maintain operating margins of 3% of revenue are usually able to add to their expendable resources over time. Clearly, deficits over time will erode these same expendable resources. The lower end of the middle strength factor (3) is therefore 3%. The lowest strength factor (1) is established at zero and below, which indicates an operating deficit. The highest strength factor (5) was established at the level of greater than 5%.

It should be noted that the Net Income Ratio for proprietaries measures pre-tax income, in comparison to total revenue. Therefore, the strength factors for proprietary institutions are increased by an estimated tax effect.

Weighting Percentages

Weighting percentages for the calculation of overall scores are also contained in the proposed Appendix F.

By applying different weighting percentages to each sector, certain ratios and the elements they measure receive greater importance than others. As with the ratios and strength factors, the weighting percentages are customized to accommodate structural and accounting differences found in each of the different sectors. Non-profit institutions retain expendable resources, and a strong balance sheet generally correlates to strong financial health. For-profit institutions, on the other hand, do not necessarily retain expendable funds in the institution. Accordingly, higher weighting percentages have been allocated to the Viability Ratios for non-profit institutions, as compared with proprietary institutions. A more detailed explanation of weighting for each sector follows.

Private and Public Non-Profits: For these institutions, balance sheet strength as evidenced by expendable fund balances or net assets correlates directly with a strong financial position. Tests using the sample group described above indicate that institutions with large expendable fund balances compared to operating size were among the strongest financially. There was a less direct correlation between the ability of an institution to operate within its means and financial strength based on a single-year snapshot. A review of rating agency medians by category also demonstrated a strong correlation between financial health and large expendable fund balances. The industry task force agreed that more emphasis should be placed on the Primary Reserve Ratio for this sector, as compared with the emphasis on the Net Income Ratio. It should be noted, however, that over time, profitability must be maintained even for these institutions, so as not to adversely affect other ratios.

Proprietaries: By their nature, proprietary institutions are expected to generate a return for their investors. This means both that a strong Net Income Ratio is important, and that one would expect that the Primary Reserve Ratio would be low as compared with non-proprietaries, since the investment return may not be retained within the business. While some amounts of expendable resources are necessary to fund ongoing operations, many different financing alternatives are available. Therefore, the Net Income Ratio is accorded the greatest weight for this sector.

Hospitals: Independent hospitals fall into two categories—for profit and non-profit. While most hospitals do rely on profitability, many also have some endowments or other similar resources. The weightings provided in Appendix F reflect the situation of for-profit hospitals. Therefore the Net Income Ration for this sector is weighted less than for the proprietary sector, but weighted more than for private non-profit and public institutions. Additionally, since hospitals have significant physical capital relative to operating size and generally use debt to finance capital additions, the Viability Ratio receives greater weight than the Primary Reserve Ratio. Adjustments to the weightings, and financial strength factors for non-profit independent hospitals will be considered in the final regulations in response to comments on this issue.

Composite Scores and the Identification of Problematic Institutions

The final step in the analysis of financial responsibility using these financial ratios is to add the weighted scores to derive a composite score. KPMG recommended dividing institutions into several categories denoting comparative levels of financial strength based on these composite scores. For these regulatory purposes, however, the relevant category is that which KPMG identified as representing an immediate financial risk. For all business sectors, this category is defined as those institutions that have a composite score of less than 1.75. This determination is based on the fact that the individual weighted scores are calibrated to measure relative financial responsibility. A composite score of less than 1.75 means that collectively, the individual ratio scores resulted in strength factors that together indicate a potentially weak financial position.

This composite score takes into consideration many variables with particular emphasis on expendable capital and profitability. A score of less than 1.75 suggests that the overall financial circumstance of the institution is such that one or more of the measured elements is at or below the minimum strength factor value and neither remaining measure is higher than the median strength factor value. Generally, this implies that the institution is having difficulty maintaining a marginal position with respect to financial health and, by at least one measure, it is failing to perform at even a minimal acceptable level. Conversely, marginal institutions that achieve a strength factor value indicating superior performance in any one of the measured elements are likely to achieve a composite score of 1.75 or more despite overall marginal performance. This is based on an assumption that superior performance in any one of the measured elements will, over time, lead to improvements the other measured elements.

The use of a composite score encompasses the total financial circumstances of the institution examined. Each of the three principle measures attempts to identify a fundamental strength or weakness related to the institution's overall fiscal health. In particular, each factor isolates a critical aspect of fiscal responsibility and measures that element against an established benchmark. It is important to note, however, that no single measure is used. Rather, the measures are blended into a composite score that explicitly recognizes the basic differences that exist among the several types of institutions. By taking these differences into consideration, the Secretary is better able to make a determination as to overall institutional fiscal health. The differences among the institutions examined are recognized explicitly through the weighting methodology.

The use of a composite measure represents a departure from the Secretary's prior approach to measuring fiscal responsibility. Previously, the Secretary applied similar measures, but individual compliance thresholds for each element were measured exclusively from one another, and not in combination. Under the prior regulations, the Secretary implicitly recognized the relationship among variables and established compliance thresholds for each element separately. The proposed regulations are similar in that poor performance in any one element may lead to a finding of non-compliance unless other measures are at least at the median performance level. What differs in relation to the previous regulations is the recognition that superior performance in one or more fundamental elements of financial health adds a dimension to any analysis of fiscal responsibility that warrants consideration. Thus, with one exception discussed below, strength in one area may be considered to the extent that it offsets weakness in another. The Secretary believes that this better takes into consideration the total financial circumstances of an institution.

There is one proposed exception to the use of the composite score rather than individual ratios as the test of financial responsibility. Based on the KPMG study, the Secretary proposes that a public or private non-profit institution would not be considered financially responsible, despite its composite score, if it has a negative Primary Reserve Ratio. This adjustment is in recognition that a public or private non-profit institution that has a negative Primary Reserve Ratio is in such grave financial difficulty that even exemplary performance in other areas cannot cover for this deficiency.

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