

DEPARTMENT OF EDUCATION

34 CFR Part 668

RIN 1840-AC36

Student Assistance General Provisions

AGENCY: Department of Education.

ACTION: Final regulations.

SUMMARY: The Secretary amends the Student Assistance General Provisions regulations (34 CFR part 668) to revise Subparts B and K and add a new Subpart L. These final regulations improve the Secretary's oversight of institutions participating in programs authorized by title IV of the Higher Education Act of 1965, as amended (title IV, HEA programs), by revising the standards of financial responsibility to provide a more accurate and comprehensive measure of an institution's financial condition. The regulations reflect the Secretary's commitment to ensuring institutional accountability and protecting the Federal interest while imposing the least possible burden on participating institutions.

DATES: Effective dates: These regulations take effect on July 1, 1998.

Applicability and Compliance Dates: The Secretary will apply the standards of financial responsibility established in these regulations to institutions that submit audited financial statements to the Department on or after July 1, 1998. However, affected parties do not have to comply with the information collection requirements in §§ 668.171(c), 668.172(c)(5), 668.174(b)(2)(i), 668.175(d)(2)(ii), 668.175(f)(2)(iii), and 668.175(g)(2)(i) until the Department publishes in the **Federal Register** the control number assigned by the Office of Management and Budget (OMB) to these information collection requirements.

FOR FURTHER INFORMATION CONTACT: For general information contact Mr. John Kolotos or Mr. Lloyd Horwich, U.S. Department of Education, 600 Independence Avenue, S.W., Room 3045, ROB-3, Washington, D.C. 20202, telephone (202) 708-8242. For information regarding accounting and compliance issues, an institution should contact the Department's Institutional Participation and Oversight Service (IPOS) Case Management Team for the state in which it is located:

IPOS Case Management Team Contacts

Boston Team, (617) 223-9338 (covering Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island and Vermont)

New York City Team, (212) 264-4022 (covering New Jersey, New York, Puerto Rico and the Virgin Islands)
Philadelphia Team, (215) 596-0247 (covering Delaware, District of Columbia, Maryland, Pennsylvania, Virginia and West Virginia)
Atlanta Team, (404) 562-6315 (covering Alabama, Florida, Georgia, Mississippi, North Carolina and South Carolina)
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Kansas City Team (816) 880-4053 (covering Iowa, Kansas, Kentucky, Missouri, Nebraska and Tennessee)
Denver Team, (303) 844-3677 (covering Colorado, Montana, North Dakota, South Dakota, Utah and Wyoming)
San Francisco Team, (415) 437-8276 (covering Arizona, California, Hawaii, Nevada, American Samoa, Guam, Federated States of Micronesia, Palau, Marshall Islands and Northern Marianas)
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SUPPLEMENTARY INFORMATION:

The following is an ordered list of the key topics covered in this preamble:

- Overview of the Standards and Provisions of Financial Responsibility.
- Community Involvement in the Regulatory Process.
- The Secretary's Responsibility for Assessing the Financial Condition of Participating Institutions.
- Need for Revising the Rules.
- The Final Rule.
- Provisions for Public Institutions.
- The Ratio Methodology for Private Non-Profit and Proprietary Institutions.
- Overview of the Methodology.
- Issues Raised in the Notice of Proposed Rulemaking and other Department Publications.
- Substantive Changes to the NPRM.
- Analysis of Comments and Changes.

On September 20, 1996, the Secretary published in the **Federal Register** a

Notice of Proposed Rulemaking (NPRM) addressing a variety of topics, including a ratio methodology that would be used in part to determine whether an institution is financially responsible (61 FR 49552-49574). The NPRM also included financial responsibility standards for third-party servicers that enter into a contract with a lender or guaranty agency, and provisions for submitting financial statement and compliance audits, adding additional locations, and changes of ownership that result in a change of control (61 FR 49552-49574). On November 29, 1996, the Secretary published final regulations governing submissions of financial statement and compliance audits and other aspects of financial responsibility, but delayed establishing final standards regarding the ratio methodology and other proposed provisions (including changes of ownership and additional locations), pending further comment, study, and review (61 FR 60565-60577).

The Secretary provided an extensive opportunity for public involvement and comment on these final regulations. On December 18, 1996, the Secretary reopened the comment period until February 18, 1997 for the delayed standards and provisions (61 FR 66854). On February 18, 1997, the Secretary extended that comment period until March 24, 1997 (62 FR 7333-7334). On March 20, 1997, the Secretary again extended the comment period until April 14, 1997 (62 FR 13520).

These regulations establish under a new Subpart L the provisions and standards of financial responsibility that an institution must satisfy to begin or continue to participate in the title IV, HEA programs. Furthermore, these regulations amend certain sections of Subparts B and K to harmonize the requirements under those sections with the provisions and standards under Subpart L. As discussed more fully under Parts 4 and 15 of the Analysis of Comments and Changes, these regulations do not establish new standards of financial responsibility for lender or guaranty agency third-party servicers, or new provisions regarding additional locations and changes of ownership.

Overview of the Standards and Provisions of Financial Responsibility

As provided under section 498 of the HEA, the Secretary determines whether an institution is financially responsible based on the extent to which an institution satisfies three statutory components, which are illustrated below.

STATUTORY COMPONENTS OF FINANCIAL RESPONSIBILITY

Financial obligations (provisions for debt payments, refunds, and repayments)	Administration of the title IV, HEA programs (past performance and program compliance provisions)	Financial condition (ratio standards)
HEA sections 498(c)(1)(C)	HEA sections 498(c)(1)(B) and 498(d)	HEA sections 498(c)(1)(A)
The extent to which an institution: (1) Satisfies its obligations to students and to the Secretary, including making refunds to students in a timely manner and repaying program liabilities to the Secretary; and (2) Is current in its debt payments.	The extent to which an institution or the persons or entities that exercise substantial control over the institution administer properly the title IV, HEA programs.	The extent to which an institution has the resources necessary to: (1) Provide and to continue to provide the education and services described in its official publications; and (2) Continue to satisfy its financial obligations.

The current standards and provisions under 34 CFR 668.15 relating to an institution's financial obligations and administration of title IV, HEA programs are detailed in the above chart and carried forward in these regulations, under §§ 668.171 and 668.174, respectively. These regulations focus on establishing a ratio methodology that provides a comprehensive measure of the financial condition of proprietary and private non-profit institutions.

The current regulations employ three independent tests for assessing the financial condition of an institution, and require an institution to satisfy the minimum standard established for each of those separate tests to be considered financially responsible.

In contrast, these regulations employ a ratio methodology under which an

institution need only satisfy a single standard—the composite score standard. Unlike the current tests that treat different measures of an institution's financial condition without reference to each other, the ratio methodology takes into account an institution's total financial resources and provides a combined score of the measures of those resources along a common scale (from negative 1.0 to positive 3.0). This new approach is more informative and allows a relative strength in one measure to mitigate a relative weakness in another measure.

Under these regulations, the Secretary considers a proprietary or private non-profit institution to be financially responsible based on its composite score. If an institution achieves a composite score of at least 1.5, it is

financially responsible without further oversight. An institution with a composite score in the zone from 1.0 to 1.4 is financially responsible, subject to additional monitoring, and may continue to participate as a financially responsible institution for up to three years.

An institution that does not satisfy either the composite score or zone standards, or that fails to meet its financial obligations or satisfy other standards of financial responsibility, may be allowed to participate in the title IV, HEA programs by qualifying under the provisions of an alternative standard. The alternative standards are described under § 668.175 of these regulations and illustrated in the following table.

ALTERNATIVE STANDARDS

Alternative	Used when:	Provisions
Letter of credit ¹ for a new institution	An institution that seeks to participate in the title IV, HEA programs for the first time does not satisfy the composite score standard but satisfies all other applicable standards and provisions.	The institution may begin to participate by submitting a letter of credit for at least 50 percent of the title IV, HEA program funds that the Secretary determines the institution will receive during its initial year of participation, as provided under § 668.175(b).
Letter of credit for a participating institution	A participating institution does not satisfy one or more of the standards of financial responsibility (including the composite score standard) or the institution's auditor expresses an adverse, qualified, or disclaimed opinion, or the auditor expresses doubt about the continued existence of the institution as a going concern.	The institution may continue to participate as a financially responsible institution by submitting a letter of credit for at least 50 percent of the title IV, HEA program funds the institution received during its last completed fiscal year, as provided under § 668.175(c).
Provisional certification	A participating institution: (1) Does not satisfy the composite score standard or any provision regarding its financial obligations; or (2) Has or had a program compliance problem as provided under § 668.174 but satisfied or resolved that problem.	The institution may participate under a provisional certification by submitting a letter of credit for at least 10 percent of the title IV, HEA program funds the institution received during its last completed fiscal year and meeting other provisions described under § 668.175(f).
Provisional certification for an institution where persons or entities owe liabilities.	The persons or entities that exercise substantial control over the institution owe a liability for a violation of a title IV, HEA program requirement.	The institution may continue to participate under a provisional certification if it satisfies the provisions described under § 668.175(g).

¹ A letter of credit is a financial instrument, typically issued by a commercial bank, whereby the bank guarantees payment to the Secretary for an amount up to the amount of the letter of credit.

A public institution demonstrates that it is financially responsible under these regulations by providing a letter from an official of the State or other government entity confirming the institution's status as a public institution.

Although the Secretary proposed to treat independent hospital institutions slightly differently under the ratio methodology, the Secretary now believes that any differences between these institutions and institutions in the other sectors relate primarily to control. Under these regulations, therefore, an independent hospital institution must satisfy the provisions of the ratio methodology established for a proprietary institution if it is a for-profit entity, or the provisions established for a private non-profit institution if it is a non-profit entity. If an independent hospital institution is a public entity, it must satisfy the requirements established for public institutions.

Community Involvement in the Regulatory Process

The Secretary sought to maximize the postsecondary education community's participation in this regulatory initiative. In developing the initial study on which the NPRM was based, the Department's contractor, KPMG Peat Marwick LLP (KPMG), consulted with a task force representing various sectors of the community. To ensure that the community was given sufficient time to analyze and comment on the proposed rules, the Secretary reopened the original comment period and then extended that comment period twice, so that the total comment period was 207 days. In response, the Secretary received approximately 850 comments during the original and extended comment periods.

Between December 18, 1996 and the publication of these final regulations, the Department took the following actions to supplement the original empirical work on which the NPRM was based, and to solicit questions, suggestions, and other comments regarding the proposed ratio methodology:

- The Department again engaged KPMG to assist the Department in reexamining the proposed ratio methodology, considering public comments and suggestions to change and improve the methodology, and conducting additional empirical studies of financial statements and other sources of information. Much of this additional work was based on suggestions made by the community.

- The Department held meetings with more than 20 representatives of higher education associations and institutions on February 5, 1997 and March 11,

1997, with nine representatives of proprietary institutions on February 27, 1997, and with four representatives of higher education associations and public institutions on April 4, 1997. The Department also conducted a number of other meetings with parties representing individual institutions or groups of institutions.

- For purposes of public consideration and comment, the Department published on the Office of Postsecondary Education's World-Wide Web site, minutes of the meetings with representatives of postsecondary education associations, information regarding possible changes to the proposed ratio methodology, and the results of some of the empirical studies. The Department also made available, for viewing on-line, the KPMG report on which the Department based the proposed ratio methodology.

Many commenters expressed their appreciation to the Secretary for the open, collaborative, and cooperative nature of this rulemaking process and for the extensive opportunities for public and community involvement. The Secretary in turn appreciates the commenters' thoughtful and constructive contributions to this process.

The Secretary's Responsibility for Assessing the Financial Condition of Participating Institutions

The statute and the legislative record show that Congress expects the Secretary to determine whether institutions participating in the title IV, HEA programs are financially sound and administratively capable of providing the education they advertise (Higher Education Amendments of 1992, Report of the Committee on Education and Labor, House of Representatives, One Hundred Second Congress, Second Session, p. 74). Congress authorized the Secretary (at that time, the Commissioner) to establish financial responsibility standards with the passage of the Education Amendments of 1976 (Pub. L. 94-482), and reinforced that authority in subsequent amendments to the HEA. In those amendments, but particularly in the legislative history leading to the 1992 Amendments, Congress made clear that the Secretary should scrutinize closely the financial condition of institutions with regard to their capacity to fulfill their educational and administrative responsibilities, and thus expected the Department to "play a more active role" in the gatekeeping process (i.e., determining whether institutions should begin to participate in the title IV, HEA programs and

overseeing participating institutions to determine whether those institutions should continue to participate).

In keeping with the statute and congressional intent, the Secretary establishes in these regulations the standards and provisions that a postsecondary institution must satisfy to demonstrate that it is financially sound enough for students to confidently invest their time and money in programs offered by the institution, and for the Federal government, on behalf of taxpayers, to provide that institution with access to substantial amounts of public funds. The Department is committed to carrying out the Secretary's gatekeeping and oversight responsibilities in a manner that ensures accountability and program integrity but that provides as much flexibility to, and places as little burden on, institutions as possible.

Need for Revising the Rules

The current regulations have enabled the Department to identify and take action against many financially weak problem institutions that drew the attention of Congress. The Secretary nevertheless believes that problems still exist that call for continued close scrutiny, and undertook an extensive process to develop more effective regulations for the following reasons.

First, the Secretary believes that the standards need to be revised to provide a more comprehensive measure of an institution's financial condition. As previously noted, the current standards provide discrete measures of certain aspects of an institution's financial condition. Those aspects are measured by three independent tests—an acid test ratio, a test for operating losses, and a test of tangible net worth. However, because each test provides a measure of financial health without regard to the other tests or to other resources available to an institution, the assessment made under each of these tests does not always reflect the overall financial condition of an institution.

Second, because the current standards do not consider the extent to which an institution satisfies or fails to satisfy the tests, the Department cannot readily make distinctions among (1) institutions that are clearly not financially healthy, (2) institutions that are financially sound enough to participate in the title IV, HEA programs, and (3) institutions whose financial health is questionable. Consequently, a more considered approach is needed to evaluate the relative level of financial health of institutions to more closely tie the Department's gatekeeping and oversight efforts to the corresponding risk to the

Federal interest posed by institutions at various levels.

Third, the Secretary believes that the current standards must be improved to properly address the different accounting, financial, and operating characteristics that exist between proprietary and private non-profit institutions.

Finally, based on KPMG's original study and the additional analysis performed during the extended comment period, the Secretary is prepared to carry out a commitment made to representatives of the postsecondary education community in the context of the promulgation of the 1994 financial responsibility regulations, that instead of establishing independent tests, the Department would assess the institutions' financial responsibility based on blended test scores.

The Final Rule

Provisions for Public Institutions

The Secretary initially proposed to apply the ratio methodology to public institutions, but, based on public comment, the Secretary has decided not to use the methodology to determine the financial responsibility of those institutions for two primary reasons. First, these institutions are subject to more public oversight and scrutiny than private non-profit and proprietary institutions. The Secretary believes that it is the responsibility of the State or responsible government entity to make available the resources necessary for those institutions to provide the education and services expected by students who enroll at those institutions and the residents of the State or locality whose funds support the institutions. Second, the legal and financial relationships between public institutions and their respective State or local governments vary widely, impacting in different ways the assets and liabilities reported on those institutions' financial statements. Thus, the ratio methodology would not treat all public institutions equitably.

In view of these and other reasons noted by the commenters (see Analysis of Comments and Changes, Part 4), the Secretary does not establish in these regulations a composite score standard for public institutions. Rather, the Secretary will rely on the statutory alternative that, in lieu of satisfying the general standards of financial responsibility (including the composite score standard), a public institution is financially responsible if its debts and liabilities are backed by the full faith and credit of the State or other

government entity. The Secretary will consider that a public institution has that backing if the institution provides a letter from the cognizant State or government entity confirming the institution's status as a public institution. The Secretary takes this approach in implementing the full faith and credit provision under section 498(c)(3)(B) of the HEA to eliminate technical and other problems experienced by public institutions in demonstrating their compliance with this provision under the current regulations.

The Ratio Methodology for Private Non-Profit and Proprietary Institutions

In developing the final regulations, the Secretary sought to address all of the needs for revising the current rules by formulating a ratio methodology, and provisions relating to the methodology, that would be fair, easily understood by institutions, and efficiently administered by the Department.

Based on the additional analysis performed by the Department and KPMG during the extended comment period, and the many helpful comments and suggestions made by the community, the Department establishes by these final regulations a ratio methodology for proprietary and private non-profit institutions that:

- (1) Provides a comprehensive measure of financial health (the composite score) by using ratios that take into account all of the resources of an institution and employing an approach under which the financial strength demonstrated in one ratio mitigates a financial weakness in another ratio;
- (2) Provides the Department the means to assess the relative health of all institutions along a common scale; and
- (3) Takes into account the key differences between these sectors of postsecondary institutions.

In so doing, the ratio methodology enables the Department to use more effectively the case management system implemented by IPOS. Under this system, case teams responsible for particular institutions have access to all of the data available to the Department regarding those institutions, including financial, compliance, and programmatic information. The case teams use this information to identify institutions whose level of financial health, or whose conduct in administering the title IV, HEA programs, or both, indicates that those institutions (1) need technical assistance, (2) must be monitored more closely, or (3) pose a risk to the Federal interest that requires the Department to initiate an adverse action.

Furthermore, in the interest of treating all institutions fairly and equitably, the Department will calculate the ratios under the methodology by using only the information contained in an institution's audited financial statements that are prepared in accordance with generally accepted accounting principles (GAAP) and by removing the effects of questionable accounting treatments.

The Secretary is committed to ensuring a smooth transition and to helping institutions understand the ratio methodology and other provisions established in these regulations by offering technical assistance, both initially and as case teams identify institutions in need of further assistance.

Overview of the Methodology

The methodology is an arithmetic means of combining different but complementary measures (ratios) of fundamental elements of financial health that yields a single measure (the composite score) representing an institution's overall financial health. Under the methodology, the composite score is calculated by:

- (1) Determining the value of each ratio;
- (2) Calculating a strength factor score for each of the ratios;
- (3) Calculating a weighted score by multiplying the strength factor score by its corresponding weighting percentage; and
- (4) Adding together the weighted scores to arrive at the composite score.

In the first step of the methodology, the values of the Primary Reserve, Equity, and Net Income ratios are calculated from information contained in an institution's audited financial statement. These ratios together measure the five fundamental elements of financial health: financial viability, liquidity, ability to borrow, capital resources, and profitability. The strength factor scores are calculated using linear algorithms (equations) and those scores reflect along a common scale the degree to which an institution in a particular sector demonstrates strength or weakness in the fundamental elements. The weighting percentages for each of the ratios make it possible to compare institutions across sectors by accounting for the relative importance that the fundamental elements have for institutions in each sector. In the final step of the methodology, the weighted scores are added together. The resulting value, the composite score, represents an overall measure of an institution's financial health.

Each step of calculating the composite score under the ratio methodology is illustrated in Appendices F and G of these regulations and discussed more fully in the following sections.

Step 1: Financial Ratios

The methodology employs three ratios that measure the same elements of financial health but are customized to reflect the accounting differences

between the sectors. The values of the ratios are determined from information contained in an institution's audited financial statement and are generically defined as follows:

For proprietary institutions:

$$\begin{aligned} \text{Primary Reserve ratio} &= \frac{\text{Adjusted Equity}}{\text{Total Expenses}} \\ \text{Equity ratio} &= \frac{\text{Modified Equity}}{\text{Modified Assets}} \\ \text{Net Income ratio} &= \frac{\text{Income Before Taxes}}{\text{Total Revenues}} \end{aligned}$$

For private non-profit institutions:

$$\begin{aligned} \text{Primary Reserve ratio} &= \frac{\text{Expendable Net Assets}}{\text{Total Expenses}} \\ \text{Equity Ratio} &= \frac{\text{Modified Net Assets}}{\text{Modified Assets}} \\ \text{Net Income ratio} &= \frac{\text{Change in Unrestricted Net Assets}}{\text{Total Unrestricted Revenues}} \end{aligned}$$

A detailed description of the components of the numerators and denominators of the ratios is provided under Appendix F of these regulations for proprietary institutions and under Appendix G for private non-profit institutions.

In view of the public comment and the empirical work performed by KPMG, the Secretary selected these ratios because together they take into account the total financial resources of an institution and provide broad measures of the following fundamental elements of financial health:

1. *Financial viability*: The ability of an institution to continue to achieve its operating objectives and fulfill its mission over the long-term;
2. *Profitability*: Whether an institution receives more or less than it spends during its fiscal year;
3. *Liquidity*: The ability of an institution to satisfy its short-term obligations with existing assets;
4. *Ability to borrow*: The ability of an institution to assume additional debt; and
5. *Capital resources*: An institution's financial and physical capital base that supports its operations.

In identifying these fundamental elements, the Secretary relied on KPMG's extensive experience in analyzing the financial condition of postsecondary institutions and the work of the community task force assembled

to assist the Department and KPMG in developing the ratio methodology.

The *Primary Reserve ratio* provides a measure of an institution's expendable or liquid resource base in relation to its overall operating size. It is, in effect, a measure of the institution's margin against adversity. The Primary Reserve ratio measures whether an institution has financial resources sufficient to support its mission—that is, whether the institution has (1) sufficient financial reserves to meet current and future operating commitments, and (2) sufficient flexibility in those reserves to meet changes in its programs, educational activities, and spending patterns. Thus, the Primary Reserve ratio provides a measure of two of the fundamental elements of financial health—financial viability and liquidity.

The *Equity ratio* provides a measure of the amount of total resources that are financed by owners' investments, contributions or accumulated earnings, depending on the type of institution, or stated another way, the amount of an institution's assets that are subject to claims of third parties. Thus, the ratio captures an institution's overall capitalization structure, and by inference its ability to borrow. With respect to the fundamental elements of financial health, the Equity ratio measures capital resources, ability to borrow, and financial viability.

The *Net Income ratio* provides a direct measure of an institution's

profitability or ability to operate within its means and is one of the primary indicators of the underlying causes of a change in an institution's financial condition.

A more thorough description of the ratios is provided under part 4 of the Analysis of Comments and Changes.

Step 2: Strength Factor Scores

The strength factor score reflects the degree to which an institution demonstrates strength or weakness in the fundamental elements as measured by the ratios. That strength or weakness is assigned a point value of not less than negative 1.0 nor more than positive 3.0, where a negative 1.0 indicates a relative weakness in the fundamental elements and a positive 3.0 indicates relative strength in those elements. The point values are assigned by a linear algorithm (equation) developed for each ratio.

For example, the linear algorithm for calculating the strength factor score for the Equity ratio of a proprietary institution is "6 X Equity ratio result." A proprietary institution with an Equity ratio equal to -0.167 would have a strength factor score of negative 1.0 (6 X -0.167 = -1.002).

The linear algorithms developed for each ratio are contained in Appendix F for proprietary institutions and Appendix G for private non-profit institutions. The algorithms are explained in greater detail under Part 6

of the Analysis of Comments and Changes.

In developing the algorithms, the Department, having consulted with KPMG, determined the value of each ratio at three critical points along the scoring scale:

- (1) The point at which an institution begins to demonstrate a minimal level of strength;
- (2) The point at which an institution demonstrates no strength; and
- (3) The point at which an institution demonstrates relative strength.

The algorithms were then constructed to yield, at these relative levels of financial health, strength factor scores of 1.0, zero, and 3.0, respectively. For example, as calculated under the algorithms, a strength factor score of 1.0 indicates that an institution has a minimal level of expendable reserves (Primary Reserve ratio), is just beginning to demonstrate equity (its assets are greater than its liabilities, but not by much) (Equity ratio), and broke even (Net Income ratio). A strength factor score of zero indicates that an institution has no expendable reserves or equity, and incurred a small loss. On the upper end of the scale, a strength factor score of 3.0 indicates that an institution has a healthy level of expendable reserves and equity (its assets are substantially greater than its liabilities) and generated operating surpluses that added to its overall wealth.

The Secretary considered carefully the comments made by the community regarding the proposed scoring scale and the impact of the proposed methodology on an institution's ability to satisfy its mission objectives. In view of these comments and the empirical work performed by KPMG during the

extended comment period, the Secretary revised the scoring scale to make greater distinctions among institutions on the lower end of the scale and to consider more fairly the actual financial health of institutions as measured by the methodology. Since the strength factor scores reflect the degree to which an institution demonstrates strength or weakness in the fundamental elements as measured by the ratios, these scores enable the Department to assess the extent to which an institution has the financial resources to:

- (1) Replace existing technology with newer technology;
- (2) Replace physical capital that wears out over time;
- (3) Recruit, retain, and re-train faculty and staff (human capital); and
- (4) Develop new programs.

A more thorough discussion of the revisions to the scoring process and strength factor scores is provided under Part 6 of the Analysis of Comments and Changes.

Step 3: Weighting Percentages

The weighting percentages for each of the ratios make it possible to compare institutions across sectors by accounting for the relative importance that the fundamental elements have for institutions in each sector. For example, expendable resources (as measured by the Primary Reserve ratio) are more important to private non-profit institutions than to proprietary institutions—proprietary institutions generally have greater access to capital markets, and owners, unlike trustees, may invest cash as needed to support operations, or may increase expendable resources by leaving earnings in the institution. On the other hand, non-profit institutions are generally

dependent on contributions from donors as their primary source of additional capital.

In this step of the methodology, the strength factor score is multiplied by a weighting percentage. For example, the weighting percentage for the Primary Reserve strength factor score of a proprietary institution is 30 percent. To determine the weighted score for a proprietary institution with a Primary Reserve strength factor score of 1.2, the institution would multiply 1.2 by 30 percent, for a weighted score of 0.36 (1.2 × 30 percent = 0.36).

The regulations revise the proposed weighting percentages to account for the effect of replacing the proposed Viability ratio with the Equity ratio and to reflect more accurately the importance of each ratio. These revisions, and the rationale for establishing the weighting percentages, are discussed more fully under Part 7 of the Analysis of Comments and Changes.

Step 4: Composite Score

In the final step of the methodology the weighted scores are added together to arrive at the composite score. Because the weighted scores reflect the strengths and weaknesses represented by the ratios and take into account the importance of those strengths and weaknesses, a strength in the weighted score of one ratio may compensate for a weakness in the weighted score of another ratio. Thus, the composite score reflects the overall financial health of an institution and provides a cardinal ranking of all institutions along a common scale from negative 1.0 to positive 3.0.

A sample calculation of a composite score is illustrated in the following chart.

CALCULATING A PROPRIETARY INSTITUTION'S COMPOSITE SCORE

Step 1	Step 2	Step 3	Step 4 ¹
Calculate the ratio results	Calculate strength factor score by use of the appropriate algorithm	Calculate weighted score (multiply strength factor score by weighting percentage)	
Primary reserve ratio = .06 .....	.06 × 20 = 1.20	1.20 × 30% = 0.36000	
Equity ratio = .27 .....	.27 × 6 = 1.620	1.620 × 40% = 0.64800	
Net income ratio = .029	(.029 × 33.3) + 1 = 1.9657	1.9657 × 30% = 0.58971	

¹ Step 4: Add the weighted scores (=1.59771) and round the total of the weighted scores to one digit after the decimal point to arrive at the composite score = 1.6.

While institutions may achieve the same composite score in different ways (by having different ratio results), institutions with the same scores are similarly situated with respect to the resources that they can bring to bear to

satisfy their obligations to students and to the Secretary.

The Regulatory Standard of Financial Responsibility

As noted previously, an institution must satisfy the standards and

provisions under each component of financial responsibility. With respect to its financial condition, an institution must achieve a composite score of at least 1.5 (the composite score standard).

In determining the minimum composite score that an institution

would need to achieve to demonstrate that it is financially responsible, the Department, having consulted with KPMG, formulated the algorithms to establish the point along the scoring scale below which an institution is clearly not financially healthy, i.e., a composite score of 1.0. From that point, the Secretary determined the level of financial health that indicates that an institution has the resources necessary not only to continue operations, but to fund to some extent its mission objectives.

An institution with a composite score of 1.0 should be able to continue operations but does not have the financial resources to meet its operating needs without difficulty, or the financial reserves necessary to deal with adverse economic events without having to rely on additional sources of capital. Moreover, because it has very limited resources, the institution will have difficulty funding its technology, capital replacement, and program needs. Below this level, an institution will have even more difficulties, if not serious difficulties, in meeting its operating needs without additional revenue or support, and in funding any of its technology, capital replacement, human capital, or program needs.

A composite score of 1.5 generally characterizes an institution that has some margin against adversity, is funding its historical capital replacement costs, and has the resources to provide funding for some investment in human and physical capital. However, the institution has no excess funds to support new program initiatives or major infrastructure upgrades.

The composite score reflects the relative financial health of institutions along the scoring scale from negative 1.0 to positive 3.0. Stated another way, any given composite score along this scale reflects the degree of uncertainty that an institution will be able to continue operations and meet its obligations to students and to the Secretary; the uncertainty that an institution will be able to continue operations and meet its obligations increases as its composite score decreases. Thus, if the Secretary's sole aim for these regulations had been to accept the lowest level of uncertainty, only institutions achieving the highest composite score would be considered financially responsible. The Secretary notes that a significant number of institutions in the samples examined by the Department and KPMG attained composite scores of 3.0 (44 percent of the institutions in the private non-profit sample, and 13 percent of the institutions in the proprietary sample).

However, the Secretary believes that a composite score of 1.5 reflects a level of financial health that is in keeping with the statutory requirements and the Secretary's goals in determining that institutions are financially responsible. This level balances the need to minimize uncertainty with the need to minimize regulatory burdens on institutions that are likely to remain in business, provide educational services at a satisfactory level, and administer properly the title IV, HEA programs.

Institutions With Composite Scores in the Zone

As noted previously, provided that an institution satisfies the standards relating to its debt payments and its administration of the title IV, HEA programs, an institution demonstrates that it is financially responsible by achieving a composite score of at least 1.5, or by achieving a composite score in the zone from 1.0 to 1.4 and meeting certain provisions.

The ratio methodology is designed to identify the point along the scoring scale where an institution is financially sound enough (a composite score of at least 1.5) to continue to participate in the title IV, HEA programs without any additional monitoring arising from a review of its financial condition, and the point below which (a composite score of less than 1.0) there is considerable uncertainty regarding an institution's ability to continue operations and meet its obligations to students and to the Secretary. For institutions scoring below 1.0, additional monitoring and surety are required immediately to protect the Federal interest.

The Secretary considers institutions with composite scores in the zone between these two points (i.e., a composite score of 1.0 to 1.4) to be financially weak but viable, and therefore allows these institutions up to three consecutive years to improve their financial condition without requiring surety. The provisions for institutions scoring in the zone are contained in § 668.175(d) of these regulations under the zone alternative.

Under those provisions, an institution qualifies initially as a financially responsible institution by achieving a composite score between 1.0 and 1.4, and continues to qualify by achieving a composite score of at least a 1.0 in each of its two subsequent fiscal years. If an institution does not achieve at least a 1.0 in each of its subsequent two fiscal years or does not sufficiently improve its financial condition so that it satisfies the 1.5 composite score standard by the end of the three-year period, the

institution may continue to participate in the title IV, HEA programs by qualifying under another alternative.

Institutions scoring in the zone should generally be able to continue operations in the short-term, absent any adverse economic events. However, even though the resources of institutions scoring in the zone are notably greater than the resources of institutions scoring below 1.0, those resources provide only a limited margin against adversity. Moreover, because zone institutions have notably less resources than institutions scoring above the zone, their ability to fund necessary mission objectives is similarly limited. In view of the limited resources of zone institutions, and the uncertainty regarding the ability of those institutions to continue operations and satisfy their obligations to students and to the Secretary in times of fiscal distress, the Secretary believes it is necessary to monitor more closely the operations of zone institutions, including their administration of title IV, HEA program funds.

Accordingly, the regulations require an institution in the zone to provide timely information regarding certain accrediting agency actions that may adversely affect the institution's ability to satisfy its obligations to students and to the Secretary, and certain financial events that may cause or lead to a deterioration of the institution's financial condition. In addition, the Secretary may require the institution to submit its compliance and financial statement audits soon after the end of its fiscal year.

With regard to the administration of title IV, HEA program funds, the Secretary provides those funds to a zone institution, or to an institution with a composite score of less than 1.0, under the reimbursement payment method or under a new payment method, cash monitoring. The Secretary establishes as part of these regulations the cash monitoring payment method in view of the public comment that the reimbursement payment method is burdensome or that it may be inappropriate for some institutions. Under either the reimbursement or cash monitoring payment method, to help ensure that title IV, HEA program funds are used for their intended purposes, an institution must first make disbursements to eligible students and parents before it requests or receives funds for those disbursements from the Secretary. However, unlike reimbursement, where an institution must provide specific and detailed documentation for each student to whom it made a disbursement, before

the Department provides title IV, HEA program funds to the institution, the Department provides funds to an institution under the cash monitoring payment in one of two less burdensome ways. The Department either requires an institution to make disbursements to eligible students or parents before drawing down title IV, HEA program funds for the amount of those disbursements, or requires the institution to submit some documentation identifying the eligible students and parents to whom a disbursement was made before the Secretary provides funds to the institution for those disbursements. Although the Secretary anticipates that the documentation requirements under cash monitoring will be minimal for most institutions, the Case Teams have the flexibility under these regulations to tailor the documentation requirements on a case-by-case basis. In addition, the Secretary expects that institutions with composite scores of less than 1.0 will continue to receive funds under the reimbursement payment method if those institutions are provisionally certified (in rare instances, however, the Secretary may provide funds under the cash monitoring payment method to an institution based in part on its compliance history and the amount of the letter of credit submitted to the Department).

The Secretary notes that the future implementation of the just-in-time payment method—which the Secretary intends to implement as soon as possible—may reduce or eliminate the use of the cash monitoring payment method. Any changes to the cash monitoring payment method arising from the implementation of the just-in-time payment method will be addressed in a future proposed regulation, and the Secretary will invite public comment on those changes. (For more information on Cash Monitoring, see the discussion under part 9 of the Analysis of Comments and Changes).

In developing these provisions, the Secretary intended to achieve three objectives. First, the Secretary wished to provide a reasonable amount of time for institutions to improve their financial condition without increasing the risks to the Federal interest. Second, the Secretary did not wish to interfere unnecessarily in the operations of institutions seeking to improve their financial condition. Third, the Secretary wished to provide as much flexibility as possible to the Department's case teams in determining the appropriate level of monitoring and oversight required of institutions in the zone.

Alternative Ways of Demonstrating Financial Responsibility

Section 498(c)(3) of the HEA provides alternatives under which the Secretary must consider an institution to be financially responsible if it fails to satisfy one or more of the components of financial responsibility. These alternatives are described under § 668.175 of the regulations. This section also contains alternatives under which the Secretary will permit an institution that does not demonstrate that it is financially responsible under the statutory provisions to continue to participate in the title IV, HEA programs.

An institution that does not achieve a composite score of 1.5, or qualify under the zone alternative, may demonstrate that it is financially responsible by submitting to the Secretary a letter of credit for at least 50 percent of the title IV, HEA program funds the institution received in its last fiscal year. If the institution's composite score is less than 1.0, it may continue to participate as a financially responsible institution by submitting the 50 percent letter of credit, or the institution may submit a smaller letter of credit (at least 10 percent of the amount of its prior year title IV, HEA program funds) and participate under a provisional certification.

As noted previously, the ratio methodology is designed to consider all of an institution's resources. In particular, the Primary Reserve and Equity ratios together reflect all of the resources accumulated over time by an institution that are available to the institution to support its current and future operations. For this and other reasons discussed under Part 7 of the Analysis of Comments and Changes, these two ratios account for 70 percent of the composite score for proprietary institutions and 80 percent for non-profit institutions.

Institutions that do not satisfy the composite score standard that would otherwise participate under the zone alternative or be required to provide a letter of credit may find that it is less costly to take the steps necessary to improve their financial condition. Based on an analysis of the data compiled by KPMG, the Secretary notes that a number of institutions scoring below the zone (i.e., have composite scores of less than 1.0) may qualify under the zone alternative by making relatively small capital infusions or increasing modestly their unrestricted net assets. For some of these institutions, the amount of the cash infusion or increase in net assets that would be necessary to achieve a

composite score of 1.0 is less than five percent of total revenue because that infusion or increase is reflected positively in both the Primary Reserve and Equity ratios. Alternatively, institutions may choose to retain more earnings. In either case, the cost to many institutions of improving their financial condition is less, sometimes far less, than the cost of securing a letter of credit.

Institutions that qualify under the zone alternative may find that by taking similar actions they can improve sufficiently their financial condition to achieve a composite score of 1.5. A zone institution that achieves a composite score of 1.5 at the end of any year in the zone or by the end of the three-year period, avoids the costs that it would otherwise incur in securing a letter of credit under the available alternatives.

More importantly, the resources that would otherwise be used, by a zone institution or an institution scoring below the zone, to secure the letter of credit would now be available to the institution to support its mission objectives. The Secretary anticipates that financially weak institutions will move into and out of the zone as those institutions demonstrate a commitment to improve their financial health. Furthermore, the Secretary expects that institutions will seek to improve their financial health in the manner that most benefits students.

Collective Guarantees

Several commenters suggested that the Secretary revise the final regulations to include an alternative under which a group of institutions could (under some type of insurance-pooling arrangement) collectively provide a letter of credit, or other financial instrument, that would serve to cover the potential liabilities of any institution in the group. The merits of this alternative are that all of the institutions in the group could continue to participate in the title IV, HEA programs as financially responsible institutions at a lower cost than if any one of those institutions posted a letter of credit on its own. In the meetings held during the extended comment period, some participants noted that the potential interest in such an alternative would depend on the nature of the final regulations.

Although the Secretary did not revise the regulations to include this suggested alternative (primarily because the commenters and meeting participants did not provide any details regarding insurance-pooling arrangements or alternative financial instruments, and because the Secretary is uncertain about the continued community interest in

this alternative), the Secretary will consider collective guarantee or insurance-pooling requests on a case-by-case basis.

Issues Raised in the Notice of Proposed Rulemaking and Other Department Publications

The September 20, 1996 NPRM included a discussion of the major issues surrounding the proposed regulations (as well as a summary of the August 1996 report by KPMG) that will not be repeated here. The following list summarizes those issues and identifies the pages of the preamble to the NPRM (61 FR 49552-49563) on which the discussion of those issues can be found:

- The scope and purpose statement of the new subpart L (p. 49556).
- A proposal to modify the precipitous closure alternative to demonstrating financial responsibility, and a clarification of the types of alternatives to demonstrating financial responsibility available to new institutions (pp. 49557-49558).
- Financial responsibility standards and other requirements for institutions undergoing a change of ownership (p. 49558).
- Past performance standards (p. 49559).
- An outline of additional requirements and administrative actions, including requirements for institutions that are provisionally certified, and an outline of administrative actions taken when an institution fails to demonstrate financial responsibility (p. 49559).
- The contents of the proposed Appendix F (p. 49559).

The following list summarizes the areas of discussion that were posted on the Department's World-Wide Web site. This site is located at (<http://www.ed.gov/offices/OPE/PPI/finanrep.html>). This web site will remain active at least until the regulations are fully effective.

- The possibility of using in the ratio analysis an Equity ratio either as an additional ratio, or as a substitute for the Viability ratio; and a discussion of the components of, and possible strength factor scores for, that ratio.
- Possible adjustments to the threshold factors to take into account new data of the effects of Financial Accounting Standards Board (FASB) Statements 116 and 117 on private non-profit institutions, and to take into account additional data on proprietary institutions.
- Possible modifications to the weighting percentages of the ratios, including the weighting for the proposed Equity ratio.

- Possible modifications to the calculation of composite scores from the ratio analysis to eliminate "cliff effects," including the possible use of a linear algorithm or the addition of more strength factor categories to linearize the composite scores.

- Possible modifications to the scoring scale, including truncating the upper end of the scale to eliminate unnecessary differentiation of institutions that attain high composite scores.

- Community suggestions regarding the treatment of goodwill in the calculation of the ratios.

- Community suggestions for a secondary tier of analysis, and suggested changes to the alternative means of demonstrating financial responsibility for those institutions that fail the ratio test.

- Discussions of the utility of using a cash flow analysis.

- Discussions of the treatment of institutional grants and other fully-funded operations in the calculation of the ratios.

- Discussions of donor income with regard to determining the financial responsibility of non-profit institutions, and in particular of institutions that have continued for many years on tight budgets with a minimal financial cushion.

- The treatment of debt in the proposed ratio methodology, including concerns that the proposed ratio methodology could penalize institutions for taking on necessary amounts of debt to expand or to invest in infrastructure, and suggestions for the evaluation of institutions that remain debt-free.

- Community suggestions for altering the proposed standards for changes of ownership.

- Discussions of the utility and practicality of using a trend analysis rather than a snapshot approach, and community suggestions that financial responsibility need not be determined annually, at least for stronger institutions.

- Community suggestions for revising the "full faith and credit" alternative for public institutions.

Substantive Changes to the NPRM

The following discussion reflects substantive changes made to the NPRM in the final regulations.

- The proposed ratio standards for public institutions have been eliminated in favor of a revised approach in implementing the statutory alternative that an institution is financially responsible if it is backed by the full faith and credit of a State or equivalent government entity.

- The proposed Viability ratio has been replaced by the Equity ratio.

- The proposed scoring scale has been modified to range from negative 1.0 to positive 3.0, rather than from 1.0 to 5.0. The low end of the range, below 1.0, indicates the poorest financial condition. At the high end, a score of 3.0 indicates financial health.

- The proposed strength factor tables have been replaced by linear algorithms.

- The proposed ratio results necessary to earn points along the scoring scale have been lowered to reflect a time frame of 12-to-18 months rather than 3-to-4 years.

- As a result of revising the scoring scale and the strength factor scores, and the change in focus from 3-to-4 years to 12-to-18 months, the minimum composite score for establishing financial responsibility has been changed from the proposed standard of 1.75 (on a scale of 1.0 to 5.0) to 1.5 (on a scale of negative 1.0 to positive 3.0).

- The proposed precipitous closure alternative has been modified and implemented in these regulations as the zone alternative. Under the zone alternative, an institution whose composite score is less than 1.5 but equal to at least 1.0 may participate in title IV, HEA programs as a financially responsible institution for up to three consecutive years.

- As part of the modifications to the proposed precipitous closure alternative, the provision requiring owners or persons exercising substantial control over an institution to provide personal financial guarantees is eliminated. Instead, an institution whose composite score is less than 1.5 is required to provide information regarding certain oversight and financial events, and the Department provides title IV, HEA program funds to that institution under the reimbursement payment method or under a new, less burdensome payment method, Cash Monitoring (discussed above and under part 9 of the Analysis of Comments and Changes).

- The proposal to apply the ratio methodology to third-party servicers entering into a contact with lenders and guaranty agencies has been withdrawn. The financial standards currently under § 668.15 continue to apply to those entities.

- The proposed revisions to the procedures relating to changes of ownership have been withheld pending further review and comment.

Executive Order 12866

These final regulations have been reviewed as significant 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 final regulations are those resulting from statutory requirements and those determined by the Secretary to be necessary for administering the title IV, HEA programs effectively and efficiently.

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

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

Summary of Potential Costs and Benefits

The potential costs and benefits of these final regulations are discussed elsewhere in this preamble under the heading Final Regulatory Flexibility Analysis (FRFA), and in the information previously stated under Supplementary Information and in the following Analysis of Comments and Changes.

Analysis of Comments and Changes

In response to the Secretary's invitation to comment on the NPRM, approximately 850 parties submitted comments. An analysis of the comments and of the changes in the regulations since the publication of the NPRM follows.

The Department received comments on these regulations from September 20, 1996 through April 14, 1997. Although the Department received and considered comments on all of the topics included in the NPRM, the comments discussed here are primarily those which address the changes to the NPRM made by these final regulations.

Major issues are discussed under the section of the regulations to which they pertain. Comments concerning the new Subpart L are grouped by topic or issue. Technical and other minor changes—and suggested changes the Secretary is not legally authorized to make under applicable statutory authority—are not addressed. An analysis of the comments received regarding the Initial Regulatory Flexibility Analysis (IRFA) can be found elsewhere in this preamble under the heading Final Regulatory Flexibility Analysis (FRFA).

Section 668.23—Compliance Audits and Audited Financial Statements

Comments: Several commenters noted that the requirements under

§ 668.23(f)(3) (previously codified under § 668.24), are not always possible to meet. Under this section, an institution's or servicer's response to the Secretary regarding notification of questioned expenditures must be based on an attestation engagement performed by the institution's or servicer's auditor. The commenters maintained that an attestation engagement is proper only when the subject of the attestation is capable of being evaluated based on reasonable, objective criteria, and that some responses to notifications of questioned expenditures may be based on grounds that could not be so evaluated, i.e., the contention that an auditor misinterpreted or misapplied a regulatory requirement when the auditor questioned the institution's or servicer's compliance or expenditure.

Discussion: The Secretary agrees that there are cases in which the institution's response to an audit does not have to be based on an attestation engagement. This provision was intended to inform institutions that new information or documentation that was not available during the original audit should be accompanied by the auditor's attestation report, when that report is submitted to the Secretary. Without the auditor's report, the resolution of the audit may be delayed or the data may not be considered reliable. However, the Secretary agrees that the necessity for the attestation engagement is determined by the nature of the response being made, and may not be required in all cases.

The Secretary also has determined that the procedures described in § 668.23(f)(1)–(3) are redundant with requirements under OMB Circulars A–128 and A–133 and the Office of Inspector General Audit Guide, and that redundancy may cause confusion for some institutions. The OMB Circulars and the Audit Guide each contain requirements that a Corrective Action Plan, which includes the institution's responses to the audit findings and questioned costs, be submitted with the audit. If the institution disagrees with the findings or believes corrective action is not needed, it provides the rationale for that belief in the Corrective Action Plan.

Normally, an institution submits information in its Corrective Action Plan, in response to a specific request from the Secretary, or as part of an appeal under 34 CFR 668 subpart H. The Secretary establishes whether an attestation report is required as part of the Secretary's request for information; the Hearing Official evaluates the reliability of information submitted with an appeal. To avoid duplication and

unnecessary audit work and because few institutions submit additional data as described in paragraph (f), the Secretary removes this paragraph.

Changes: The Secretary removes paragraph (f) under § 668.23.

Subpart L—Financial Responsibility

Part 1. General Comments Regarding the Proposed Ratio Methodology

Comments: Many participants involved in the discussions conducted by the Secretary during the extended comment period expressed the view that the manner in which those discussions were conducted demonstrated the Department's commitment to public and community involvement in the rulemaking process and should serve as a model for future rulemaking.

Several commenters maintained that the Secretary cannot change the current standards of financial responsibility without first convening regional meetings to obtain public involvement in the development of proposed regulations as provided under the negotiated rulemaking process described in section 492 of the HEA. One commenter opined that absent a negotiated rulemaking process the Secretary could not promulgate regulations that would have legal force and effect.

Several commenters argued that the proposed ratio methodology is contrary to statutory provisions under section 498 of the HEA because the proposed ratios do not include the type of ratios specified by the HEA.

Other commenters maintained that any attempt by the Secretary to promulgate financial responsibility standards was duplicative, and that for reasons of efficiency and regulatory relief the Secretary should rely upon standards used by financial institutions and accrediting agencies.

Discussion: The Secretary appreciates the participants' remarks and thanks those persons for their valuable input regarding the direction and development of these rules. The Secretary disagrees that negotiated rulemaking is required under the HEA to implement these regulations. In accordance with section 492 of the HEA, the Secretary conducted regional meetings to obtain public involvement in the preparation of draft regulations for parts B, G and H of the HEA as amended by the Higher Education Amendments of 1992. As required under section 492, those draft regulations were then used in a negotiated rulemaking process that was subject to specific time limits connected with the enactment of the 1992

Amendments. The negotiated rulemaking requirement was therefore anchored at one end by the statutorily required regional meetings that followed the enactment of the 1992 Amendments, and at the other end by fixed time limits for the final regulations created by that process. Subsequent regulatory changes to these sections cannot be tied to those requirements for negotiated rulemaking because the regional meetings and statutory timeframes for those regulations have already passed. The HEA does not restrict the Secretary's authority to make additional regulatory changes in this area, and changes to the regulations may therefore be made without using negotiated rulemaking.

Even though negotiated rulemaking was not required for these regulations, the Secretary believes that the opportunities afforded to the higher education community during the extended comment period to provide input regarding the proposed regulations are consistent with the spirit of cooperation that underlies the negotiated rulemaking process. In the numerous meetings held during the extended comment period with representatives from institutions, higher education associations, and other interested parties, the meeting participants identified many areas in the proposed regulations that the Secretary has since modified and improved to more accurately measure the relative financial health of institutions.

The Secretary disagrees that section 498(c)(2) of the HEA requires the Secretary to utilize particular ratios in determining financial responsibility. That section of the HEA merely provides examples of ratios that the Secretary may use in determining whether an institution is financially responsible, e.g., the statutory reference to an "asset to liabilities" ratio is a generic rather than a specific reference or requirement. Moreover, the Secretary believes that the ratio methodology established by these regulations not only incorporates the same aspects of financial health as the ratios illustrated in the HEA, but does so in a more comprehensive manner.

With respect to the comments that the Secretary should rely on financial determinations made by accrediting agencies or financial institutions, the Secretary notes that section 498(c) of the HEA requires the Secretary to make those determinations for institutions participating in the title IV, HEA programs. In addition, because the financial standards used by other parties reflect the mission of those parties or are used by those parties to initiate or continue a business relationship, there

is no assurance that determinations made under those standards by those parties will have a direct bearing on whether an institution is financially responsible for the purposes required under HEA, i.e., that the institution is able to (1) provide the services described in its official publications, (2) administer properly the title IV, HEA programs in which it participates, and (3) meet all of its financial obligations to students and to the Secretary. Moreover, and absent any provision in the statute that permits the Secretary to delegate financial responsibility determinations to other parties, if the Secretary adopted the commenters' suggestion, similarly situated institutions would be treated differently depending on the party making the determination.

Changes: None.

Part 2. Comments Regarding the Timing and Implementation of New Financial Standards

Comments: Several commenters recommended that the Secretary postpone any changes to the financial responsibility standards until after reauthorization of the HEA. The commenters argued that if new standards are implemented now, these standards might be changed during the reauthorization process or the statute may be amended to include other requirements, thus potentially subjecting institutions to several different requirements within a few years. Another commenter suggested that the proposed standards form the starting point for discussions between the Secretary and the higher education community on reauthorization issues involving financial responsibility.

Many commenters believed that the reporting requirements under FASB 116, Accounting for Contributions Received and Contributions Made, and FASB 117, Financial Statements of Not-for-Profit Organizations, are too recent to be thoroughly understood. In particular, the commenters maintained that since the impact of these FASB requirements on the proposed ratio methodology is not known, the Secretary should delay publishing final rules. Along the same lines, commenters representing proprietary institutions maintained that the Secretary should not promulgate the ratio methodology because it is untested and its impact on the community is not known.

Discussion: The Secretary believes that changes to the current financial responsibility standards are necessary for the reasons cited in the preamble to this regulation (see the discussion under the heading *Need for Revising the Rules*

in the **SUPPLEMENTARY INFORMATION** section of these regulations).

With regard to new accounting standards under FASB Statements 116 and 117, since most private non-profit colleges and universities adopted the new FASB standards for their fiscal years that ended June 30, 1996, only a limited number of financial statements prepared under those standards were available for examination at the time the NPRM was published. Based on that limited number of financial statements, the proposed strength factors for the Primary Reserve ratio were set approximately 66 percent higher than strength factors for institutions under a fund accounting model (AICPA Audit Guide financial reporting model). This increase in the strength factors was intended to reflect the fact that under FASB 116/117 realized and unrealized gains on investments held as endowments are included in unrestricted or temporarily restricted net assets, whereas under fund accounting these gains were generally treated as nonexpendable assets. Therefore, it was anticipated that the expendable net assets of all institutions would increase significantly.

During the extended comment period KPMG conducted an analysis of financial statements from 395 non-profit institutions that adopted FASB 116/117 and found that the impact of the new accounting standards is not uniform across the private non-profit sector. The anticipated impact that expendable net assets would increase significantly occurred only among institutions holding large endowments; the impact was negligible for institutions with little or no endowment. Based on the more thorough KPMG analysis, the Secretary revises the strength factors for the Primary Reserve ratio for private non-profit institutions in a manner that discounts the effects of the new FASB standards for all non-profit institutions.

Changes: See the discussion of the strength factor score for the Primary Reserve ratio, Analysis of Comments and Changes, Part 6.

Comments: A commenter representing proprietary institutions questioned the manner in which the KPMG study was conducted. The commenter believed that small business interests were not considered since no representatives of small proprietary institutions were among those institutional representatives that assisted with the KPMG study. Moreover, the commenter implied that the Secretary did not consider the comments submitted by a group of CPAs on behalf of proprietary institutions regarding the KPMG report, and therefore may have violated the

requirement in the Regulatory Flexibility Act (RFA) that the Secretary confer with representatives of small businesses.

Discussion: The Secretary notes that the suggestions of the group of CPAs referenced by the commenters were considered in developing these final regulations. More significantly, however, during the extended comment period the Secretary sought and obtained the views and comments of individuals and organizations with diverse experience in higher education finance. Specifically, the Secretary met with organizations representing proprietary institutions and directly with persons from proprietary institutions, including representatives from small institutions. In addition the Secretary provided on the Department's web site a summary of the views expressed by the participants at those meetings and additional information regarding the ratio methodology.

Changes: None.

Part 3. Comments Regarding Annual Determinations of Financial Responsibility

Comments: Many commenters from private non-profit institutions maintained that institutions should not be subjected to annual determinations of financial responsibility. The commenters believed that annual determinations are unnecessarily burdensome, and represent an inefficient use of the Secretary's resources, particularly in cases in which an institution has been recently recertified. The commenters opined that when a determination is made during the recertification process that an institution is financially responsible, the Secretary has sufficiently discharged his oversight responsibilities in this area.

Discussion: The Secretary believes that it is not prudent to ignore the financial condition of many institutions for the three- to four-year period between recertification cycles for several reasons. First, the financial condition of an institution may deteriorate, increasing unnecessarily the risks to students and taxpayers that the institution will close or will otherwise be unable to meet its obligations. Second, many institutions prepare an annual audited financial statement for other purposes, so the only burden that may result from an annual determination stems from the institution's failure to satisfy the standards of financial responsibility. Lastly, if the Secretary were to adopt the commenters' suggestion by establishing longer term financial standards for all institutions, those standards would

necessarily need to be much higher than the standards in these regulations, resulting in more institutions failing the standards and creating additional burdens for those institutions and the Secretary. Nevertheless, the Secretary may in the future explore the possibility of determining the financial responsibility of certain institutions less often or only during the recertification process.

Changes: None.

Part 4. Comments Regarding the Adequacy and Appropriateness of the Proposed Ratio Methodology

General comments: Many commenters from a variety of sectors supported the direction taken by the proposed regulations, including customizing the ratios for each sector. The commenters agreed with the Secretary that the proposed methodology provides a better assessment of an institution's financial condition than the regulatory tests currently in place. However, the commenters believed that some changes should be made to the proposed regulations.

Several commenters asserted that the proposed ratio methodology is inadequate because it does not consider other factors, such as enrollment trends, used by credit rating agencies like Moody's or Standard and Poor's. The commenters suggested that along with using the proposed methodology, the Secretary should consider an institution's Moody's or Standard and Poor's credit rating, and the institution's history of handling Federal funds, before the Secretary determines whether the institution is financially responsible.

Similarly, one commenter from a non-profit institution argued that credit rating agencies place a significant emphasis on the strength of an organization's revenue stream, but the proposed ratios virtually ignore this variable. The commenter stated that in assessing the revenue strength of educational institutions, the rating agencies typically review such data as average SAT scores and student acceptance rates. It was the commenter's view that a revenue strength score should be part of the evaluation process and should carry no lesser weight than that associated with expenses.

Other commenters from non-profit institutions maintained the ratio methodology is not valid because it is not based on traditional measures of financial strength, and did not take into account the institution's total financial circumstances as required by the HEA. Another commenter from the non-profit sector argued that the proposed rules, because of their emphasis on

profitability, appeared to be designed for proprietary institutions. The commenter urged the Secretary to amend the rules to reflect the difference in each sector. Several other commenters from private non-profit institutions asserted that the proposed ratio methodology is deficient because it does not take into account specific missions of institutions.

Several commenters believed that the proposed methodology is too restrictive, arguing that it is too heavily biased in safeguarding the Secretary from events that are very rare.

Several other commenters representing proprietary institutions maintained that the new methodology was incomplete because it contained no way to measure the effectiveness of an institution's management.

Other commenters believed that many small institutions with good educational and compliance records that pass the standards proposed in the NPRM. The commenters opined that this outcome points to a flaw in the manner in which the methodology treats small institutions. An accountant for a proprietary institution argued that because the proposed methodology does not provide an adjustment for size, it is unfair to compare an institution with \$10 million in tuition revenue to an institution with \$500,000 in tuition revenue by applying the same standards and criteria to both institutions.

Several commenters maintained that the proposed methodology is complex and difficult to understand. The commenters argued that the proposed rules will require institutions to rely more heavily on CPAs, thus increasing their costs.

Discussion: The Secretary thanks the commenters supporting the approach taken under these rules to establish better, more comprehensive financial standards and appreciates the cooperation and effort of commenters and other participants in the rulemaking process for sharing their views and concerns with the Secretary during the initial and extended comment periods.

With regard to the concerns raised by the commenters about the adequacy of the ratio methodology, the Secretary wishes to make the following points. First, the ratio methodology is designed to make appropriate, albeit broad, distinctions between the sectors of higher education institutions. The Secretary acknowledges that the methodology does not directly consider intra-sector differences nor does it take into account all of the variables or elements suggested by the commenters regarding the mission or organizational

structure of institutions. To do so would create an enormously complex model that as a practical matter would be impossible to implement. Rather, the methodology focuses on key ratios and differences between the sectors that the Secretary believes are the most critical in evaluating fairly the relative financial health of all institutions along a common scale.

Second, the adequacy of the ratio methodology should be judged in the context of both its design objectives and the associated regulatory provisions that complement those objectives. In developing these regulations the Secretary sought to minimize two potential errors—that a financially healthy institution would fail the ratio standard and be inappropriately subject to additional requirements and burdens, and that a financially weak institution would satisfy the ratio standard and later fail to carry out its obligations at the expense of students and taxpayers. The ratio methodology, in combination with the alternative standards established by these regulations (see Analysis of Comments and Changes, Part 9), reflects the Secretary's decision to err on the side of allowing some financially weak institutions to participate in the title IV, HEA programs but in a manner that protects the Federal interest.

Third, the Secretary disagrees that the ratio methodology is flawed because it does not provide an adjustment for the size of an institution. To the contrary, an adjustment for size is unnecessary because a ratio converts amounts into a metric that is relative to an institution's own size, making possible a comparison of that institution to other institutions regardless of the size of those institutions. This comparative analysis is the basic design element of the ratio methodology that enables the Secretary to evaluate the relative financial health of all institutions along a common scale.

Similarly, the Secretary disagrees that the methodology favors large or publicly traded institutions. Presumably, the commenters are referring to a situation where a large institution is not dependent upon a single revenue stream or has access to wider donor bases or more capital markets than a small institution. While this flexibility may advantage a large institution, the Secretary believes that flexibility is inherent to the institution and beyond the scope of the methodology. The fact that a large institution may be able to improve its financial condition by managing its resources effectively also holds true for a small institution, particularly since the ratios account for

an institution's performance relative to its size.

With regard to the comment from the non-profit sector that the proposed ratio methodology appeared to be designed for proprietary institutions because it emphasized profitability, the Secretary notes that the measure of profitability (the Net Income ratio) accounted for 50 percent of the composite score for proprietary institutions, but for only 10 percent of the composite score for non-profit institutions. As discussed more fully under Part 7 of the Analysis of Comments and Changes (Comments regarding the weighting of the proposed ratios), the Secretary has revised the proposed percentages for the Net Income ratio to more accurately reflect the differences between the sectors of postsecondary institutions.

The Secretary disagrees that the methodology will require institutions to rely more heavily on CPAs. As illustrated in the appendices to these regulations, an institution can readily calculate its composite score from its audited financial statements, provided that those statements are prepared in accordance with GAAP. Furthermore, by limiting the number of ratios, the Secretary believes that it should not be difficult for any institution to determine the impact that its business and programmatic decisions have or will have on its financial condition as measured by the methodology.

Changes: None.

Comments regarding alternative ratios: Several commenters argued that the proposed ratio methodology is limited and arbitrary, suggesting alternative ratios that should be used instead, including: the acid test ratio; a debt to equity ratio; a title IV, HEA loan program default ratio; a debt to revenue ratio; a longevity ratio; a debt service coverage ratio; and a measure of working capital.

Several commenters believed that the Primary Reserve ratio disadvantages institutions that converted short-term liabilities into long-term debt to meet the acid test ratio requirement.

A commenter from an accrediting agency asserted that the composite score based on the proposed ratio methodology is inadequate in assessing an institution's financial health, and that other measures such as operating income, debt levels, availability of working capital, and significant items contained in notes to the financial statements should be used instead.

Discussion: The Secretary considered a number of ratios that could be used in addition to or in place of the proposed ratios, including the ratios suggested by the commenters, but decided to replace

only the proposed Viability ratio, with an Equity ratio. As discussed below, while the ratios suggested by the commenters are valid measures, taken individually or as a whole they measure the financial health of an institution more narrowly than do the ratios established by these regulations. In selecting the ratios, the Secretary considered the extent to which those ratios provided broad measures of the following fundamental elements of financial health:

1. *Financial viability:* The ability of an institution to continue to achieve its operating objectives and fulfill its mission over the long-term;

2. *Profitability:* Whether an institution receives more or less than it spends during its fiscal year;

3. *Liquidity:* The ability of an institution to satisfy its short-term obligations with existing assets;

4. *Ability to borrow:* The ability of an institution to assume additional debt; and

5. *Capital resources:* An institution's financial and physical capital base that supports its operations.

The Secretary believes that the ratios used in the methodology, Primary Reserve, Equity, and Net Income, not only measure these fundamental elements well, but that they do so in a manner that takes into account the total resources of an institution. With respect to the ratios suggested by the commenters, the Secretary wishes to make the following points.

The Secretary agrees that the acid test ratio (cash and cash equivalents divided by current liabilities) is a useful measure of highly liquid assets available to meet current obligations, and it is used in the current regulations as a test of financial responsibility. However, the acid test is not included in the ratio methodology for several reasons. First, it has been the Department's experience that certain institutions manipulate the ratio elements to satisfy the 1:1 acid test standard, such as by reclassifying current liabilities as long-term liabilities. Second, the information needed to calculate the ratio is difficult to extract from the financial statements prepared for non-profit institutions because that information is not a required disclosure (assets and liabilities are not necessarily classified on those financial statements as current and noncurrent). Moreover, expendable capital (as measured by the Primary Reserve ratio) is a broader and more important element of financial health than highly liquid capital, because it mitigates the effects of differing cash management and investment strategies used by institutions. For example, an

institution that invests excess cash in other than short-term instruments may fail the acid test requirement, whereas that excess cash, regardless of how it is invested, is considered an expendable resource under the Primary Reserve ratio. For these same reasons, Working Capital ratios (working capital is the difference between current assets and current liabilities) are not included in the methodology.

With respect to Cash Flow ratios, the Secretary considered several measures of cash provided from operations to cover debt payments. However, cash flow (taken directly from the Cash Flow Statement) can be easily manipulated. For example, delaying payment to creditors by simply extending the normal payment terms to 120 days would give the appearance that cash has been provided by operations. Therefore, the Secretary decided to retain the Net Income ratio which, as an accrual-based measure, recognizes expenses when they are incurred, not when they are paid.

The Secretary considered an Operating Income ratio that would measure income from operations as a percentage of net revenue, but the results of that ratio would only partially address the question of whether an institution operated within its means during its fiscal year. By comparison, the Net Income ratio measures net income as a percentage of net revenues after operations and other non-operating items and thus provides a more complete measure of whether an institution spent more than it brought in during the fiscal year.

The Secretary also considered adjusting the Net Income ratio for non-cash items, but decided instead to make an allowance for the largest non-cash item—depreciation expense—in the strength factors for this ratio (see Analysis of Comments and Changes, part 6).

With regard to the Debt to Equity ratio and the other suggested Debt ratios, the Secretary notes that, like the proposed Viability ratio, these ratios cannot be applied universally. Based on the audited financial statements reviewed by KPMG during the extended comment period, approximately 35 percent of proprietary institutions and 13 percent of private non-profit institutions have no debt. In addition, Debt to Revenue and Debt Service Coverage ratios, while providing insight as to how the institution is managing its debt, are less important than a measure of leverage itself. For these and other reasons, the Secretary includes in the ratio methodology an Equity ratio (tangible

equity divided by tangible total assets) as the primary measure of leverage.

The Secretary is not convinced that the utility of a Longevity measure or ratio is on par with the utility of the ratios used in the methodology. Unlike the ratios used in the methodology that measure the actual financial condition of an institution, it is not clear how a Longevity measure could be used as part of the methodology. A Longevity measure merely implies that an institution that has been operating for many years will continue to operate, but provides no insight regarding the institution's current financial condition or its ability to satisfy its obligations. Moreover, a Longevity measure cannot be used as an independent test because it has no predictive value at the institutional level. Based on data obtained from Dun & Bradstreet regarding the probabilities of credit stress and bankruptcy, the Secretary found that institutions that have been in existence for more than 30 years have on average more likelihood of enduring credit stress and less likelihood of going bankrupt than institutions that are less than 30 years old. However, there were a significant number of institutions in the data group that have been in existence for more than 30 years that were rated by Dun & Bradstreet as representing high risks of late payments or financial failure. In addition, the Secretary reviewed the files of closed institutions and found that a significant percentage of those institutions (12 percent) were in existence for more than 25 years.

With regard to the notes to financial statements and independent accountants' reports, the Secretary wishes to clarify that these notes and reports are reviewed by the Secretary to determine if an institution complies with other standards or elements of financial responsibility. For example, if an auditor expresses a "going-concern" opinion, the institution is not financially responsible even if it satisfies all other standards. However, the information contained in the notes and reports does not always constitute a sufficient basis on which the Secretary makes or can make a determination of financial responsibility.

Changes: The proposed ratio methodology is revised, in part, by replacing the Viability ratio with the Equity ratio.

Comments regarding the use of ratios: One commenter from the proprietary sector argued that the proposed ratio methodology should not be used to determine that an institution is not financially responsible. The commenter stated that the AICPA CPA/MAS

Technical Consulting Practice Aid No. 3 warns of the shortcomings of ratio analysis, including improper comparisons that do not take into account size, geographical location and business practices, and other variables such as depreciation and number of years considered by that analysis. Based on these shortcomings, the commenter concluded that a financially strong institution may fail to achieve the required composite score requirement or be forced to make unsound business decisions solely to meet the requirement. Although the commenter believed that the proposed ratio methodology could be used to determine that an institution is financially responsible, the commenter recommended that the Secretary allow an institution that fails to achieve the composite score to demonstrate its financial strength without imposing the letter of credit requirement.

Discussion: The Secretary disagrees. The practice aid is specifically designed to provide a consulting or accounting practitioner illustrative examples of the use of financial ratio analysis techniques in performing a comparative analysis of a client organization with other appropriate organizations.

The "shortcomings" referred to by the commenter relate to factors that should be considered by the practitioner in understanding the differences that may occur between comparable companies and explaining those differences to the client. To the extent practicable, the ratio methodology developed for these regulations mitigates these differences by evaluating the financial health of an institution relative to other institutions, and by measuring an institution's financial health against a minimum standard established by the Secretary. In addition, the individual ratio definitions are constructed to account for reporting and accounting differences between the sectors of higher education institutions. While other factors, such as operating structure, could affect an institution's performance, the consequences of those factors reflect management decisions that fall outside the scope of the Secretary's review.

Changes: None.

Comments regarding public institutions: One commenter argued that there is no need for Federal financial standards for public institutions for several reasons.

First, the commenter maintained that there is no danger of a "precipitous closure" of a public institution because, in his State, the closure of a State college or university requires the approval of the State General Assembly. Moreover, the commenter believed that

in authorizing a closure, the General Assembly would be careful to protect the interests of students and all creditors. In any event, the commenter opined that the Secretary could recover any monies due from a closed State institution by offset against future aid to other State institutions. For local public institutions (community colleges), the commenter stated that, in his State, a closure would have to be approved in a general election. However, the closure of a local institution cannot adversely affect student refunds or other liabilities of the institution because State law requires the continuance of property tax assessments until all debts of the institution are paid in full.

Second, the commenter noted that public institutions are subject to far more official oversight than private or proprietary institutions. In his State, the activities of State institutions are monitored by, among others, the State Controller, the State Auditor, and the State Commission on Higher Education.

Third, the commenter pointed out that public institutions are subject to more public scrutiny than are private and proprietary institutions, i.e., public institutions conduct their affairs in public, publish budgets, hold governing board meetings that are open to the public, and make their financial statements available for public inspection. The commenter believed strongly that this scrutiny enhances the financial responsibility of public institutions.

Fourth, the commenter noted that the 1973 AICPA Audit Guide is obsolete for colleges and universities under FASB jurisdiction and will soon be obsolete for other public institutions. The commenter stated that the Government Accounting Standards Board (GASB) intends to publish an exposure draft on its Colleges and Universities Reporting Model at the end of March 1997 and a final Statement of Financial Reporting Standards in the second quarter of 1998. According to the commenter, since the proposed reporting model makes major changes to public institutions' financial statements, it is unlikely that any ratio definitions based on the 1973 AICPA Audit Guide will be useful when the new model takes effect (probably the fiscal year starting in 2000). The commenter suggested therefore that the Secretary delay promulgating financial ratio standards for public institutions until the new GASB standards are in effect.

Next, the commenter argued that the proposed methodology's reliance on profits and expendable fund balances is inappropriate for public institutions, and may be contrary to State public

policy. The commenter believed that unlike private non-profit and proprietary institutions that need to have sufficient reserves (or be able to generate the profits necessary to accumulate sufficient reserves) to continue operations during economic fluctuations, public institutions have much less need for reserves because their major funding sources are less susceptible to those fluctuations.

In addition, the commenter stated that in his State, public policy prohibits State institutions from accumulating large expendable funds balances. The State General Assembly appropriates funds for the purpose of meeting the immediate education needs of State residents and not for creating institutional reserves. The commenter continued that consistent with this policy, the State does not fund colleges and universities for the long-term compensated absence liabilities that those institutions are required to accrue under GASB Statement No. 16 (the State funds these liabilities when they become due). Consequently, the commenter believed that the existence of these liabilities virtually guarantees that smaller State institutions will fail the proposed ratio standards. Moreover, the commenter argued that the proposed ratio standards do not sufficiently recognize the differences between public sector financial reporting requirements (GASB) and private sector requirements (FASB).

Several other commenters maintained that some State institutions would not achieve the required composite score if they are required to include in the calculation of the proposed ratios, items that are beyond the control of those institutions. Therefore, the commenters suggested that it would be fairer to allow State institutions to exclude from the ratio analysis items such as plant debt and certain employee benefits that are the obligation of the State or funded by the State.

For several reasons, commenters representing public institutions believed that the Secretary should amend proposed § 668.174(a)(1). Under this section, an institution that fails to achieve the required composite score may demonstrate to the Secretary that it is nevertheless financially responsible if the institution's liabilities are backed by the full faith and credit of the State or by an equivalent government entity. First, the commenters recommended that the Secretary qualify the term "liabilities" by adding the phrase "that may arise from the institution's participation in the title IV, HEA programs." In support of this recommendation, the commenters noted

that in both of the other alternatives under this section, liabilities are either based on or limited to the amount of title IV, HEA program funds received by an institution. Moreover, the commenters argued that if the Secretary interprets "liabilities" to mean all balance sheet liabilities of an institution, the State would have to accept these liabilities as General Obligations of the State. According to the commenters, since most States have constitutional prohibitions against general obligation debt, States would be prohibited from providing the required backing for any institution that has revenue bonds or similar debt outstanding.

Next, the commenters recommended that the Secretary amend the term "equivalent government entity" by adding the phrase "including local governments or separate districts with taxing authority" to clarify that the guarantee required under § 668.174(a)(1) may be provided by any entity that has the taxing power to validate its guarantee.

Discussion: The Secretary agrees with many of the points made by the commenters and therefore does not establish in these regulations a composite score standard for public institutions. Instead of satisfying the composite score standard, an institution must notify the Secretary that it is designated as a public institution by the State, local or municipal government entity, tribal authority, or other government entity that has the legal authority to make that designation, and provide a letter from an official of that State or government entity confirming that it is a public institution.

Changes: The composite score standard and Primary Reserve requirements proposed under § 668.172(a)(1)(i) and (ii) for public institutions are eliminated. The replacement provisions described above are relocated under § 668.171(c).

Comments regarding third-party servicers: Several commenters believed strongly that the proposed regulations are unsuitable for third-party servicers, noting that the KPMG study did not include an analysis of third-party servicers. The commenters argued that the servicer business sector is fundamentally different from any type of institutional educational sector, pointing out that the contractual obligations and legal structures of servicers are different than those of institutions.

In addition, the commenters contended that while the proposed requirements regarding alternative financial standards and the actions the

Secretary may take against entities that fail to satisfy the standards may be appropriate for institutions, these alternate standards and actions are not applicable or appropriate for third-party servicers. For these reasons, the commenters requested the Secretary to put aside the proposed rules and work with third-party servicers to formulate new, more applicable rules.

Several other commenters representing third-party servicers argued that since the proposed methodology favors entities with high equity and low debt, it is inappropriate for third-party servicers that have low equity and high debt but generate high income streams. Moreover, the commenters noted that while the Secretary consulted with third-party servicers in establishing the current regulations (as part of the Negotiated Rulemaking process), third-party servicers were not consulted before these proposed rules were published. Therefore, the commenters recommended that the Secretary continue to evaluate third-party servicers under the current regulations.

Several commenters representing third-party servicers maintained that the alternative of submitting a letter of credit of up to 50 percent of title IV, HEA program funds does not apply to third-party servicers. The commenters suggested instead that third-party servicers that are collection agencies for FFELP funds post a fidelity bond in the amount equal to the amount held each month by the agency in its trust account on behalf of the guarantors prior to remittance to the guarantor. These commenters argued that such a standard represents the current industry practice to protect guaranty agencies with which a collection agency contracts, from loss caused by the agency's actions.

Discussion: The Secretary agrees to develop in the future financial standards solely for third-party servicers. In the meantime, those servicers must comply with the requirements under 34 CFR Parts 668 and 682.

Changes: The third-party servicer requirements under proposed § 668.171(b) are removed.

Part 5. General Comments Regarding the Proposed Ratios

Comments regarding the Primary Reserve ratio: Many commenters opposed the requirement that public and private non-profit institutions must have a positive Primary Reserve ratio to meet the general standards of financial responsibility. The commenters maintained that this requirement represents a separate, single standard,

contradicting both the intent of proposed ratio methodology and the statutory requirement that the Secretary consider an institution's total financial condition.

Several commenters from non-profit institutions believed that the Primary Reserve ratio favors colleges and universities that accumulate resources to safeguard Federal funds rather than expend those resources to provide student services. The commenters argued that this preference is not only contrary to the operation and mission of most colleges and universities, it will result in inflationary pressures that create tuition increases.

Several commenters argued that institutions will be forced to reduce teaching and other staff to attain adequate scores for the Primary Reserve ratio. The commenters reasoned that reducing "total expenses" to improve the ratio score necessarily reduces salaries and wages for teachers and staff because salaries and wages comprise the largest component of "total expenses" at most institutions.

A commenter from a non-profit institution argued that expended title IV, HEA program funds should be subtracted from "total expenses" because these funds are not included in "total unrestricted income." Likewise, the commenter believed that revenues expended from restricted endowments should not be included in "total expenses" if those funds are not counted in "total unrestricted income."

Other commenters opined that the Primary Reserve ratio treats non-profit institutions unfairly because the numerator excludes most restricted assets, but the denominator does not exclude the expenses attributable to those assets.

Some commenters suggested that the Secretary refine the term "expenses" in several ways. First, it should be adjusted so that it reflects cash consumption rather than non-cash accounting charges—such non-cash charges as depreciation and amortization expense should be eliminated, while principal repayments on debt should be added. Second, expenses associated with sponsored programs should be eliminated. These commenters, and other commenters, maintained that sponsored program expenses, such as those associated with the U.S. Government-sponsored scientific research programs, are a function of those research programs and can generally be eliminated upon termination of those programs (during the course of the program, expenses are funded by revenues received from the sponsoring agency). The commenters

concluded that the Secretary should not penalize an institution whose researchers are capable of generating significant grants.

Discussion: The Primary Reserve ratio provides a measure of an institution's expendable or liquid resource base in relation to its overall operating size. It is, in effect, a measure of the institution's margin against adversity. Specifically, the Primary Reserve ratio measures whether an institution has financial resources sufficient to support its mission—that is, whether the institution has (1) sufficient financial reserves to meet current and future operating commitments, and (2) sufficient flexibility in those reserves to meet changes in its programs, educational activities, and spending patterns. Therefore, the Secretary continues to believe that an institution with a negative Primary Reserve ratio has serious financial difficulties.

If an institution's Primary Reserve ratio is negative, expendable net assets are in a deficit position. In those cases the institution will need to generate surpluses to replenish the deficit, or may be forced to draw on other resources or sell off assets to make ends meet, thus increasing the uncertainty that the institution will be able to meet its obligations. However, because an Equity ratio is now included in the methodology, the Secretary eliminates the proposed provision that a non-profit institution is not financially responsible if it has a negative Primary Reserve ratio. The Equity ratio measures the amount of total resources that are financed by owners' investments, contributions, or accumulated earnings (or conversely, the amount of total resources that are subject to claims of third parties) and thus captures an institution's overall capitalization structure and, by inference, its overall leverage. Because the Equity ratio supplements the measure of the amount of expendable reserves provided by the Primary Reserve ratio with a measure of other capital resources available to support the institution, it provides a measure of resources that could mitigate the effects of a negative Primary Reserve ratio.

With regard to the comments about total expenses, those expenses, including salaries paid to faculty and staff, are part of the commitment of an institution to provide services to students. The relative size of each component in an institution's annual operating budget is a management decision. In addition, the Secretary notes that based on the AICPA Audit Guide for Not-for-Profit Organizations issued on June 1, 1996, most title IV,

HEA program funds will not be included in total expenses of colleges and universities. For example, payments made to those institutions under the Direct Loan, Federal Family Education Loan, Federal Pell Grant, and Federal Supplementary Educational Opportunity Grant programs are not included in total expenses reported on the statement of activities. In addition, the Audit Guide will require scholarship expenses to be netted against tuition income in the revenue portion of the statement.

The Secretary disagrees that the definition of the term "expenses" as used in the Primary Reserve ratio should exclude non-cash charges such as depreciation and amortization and, except in certain circumstances, sponsored program expenses. The Primary Reserve ratio measures an institution's expendable or liquid resource base in relation to its overall operating size. Operating size is the total of all expenses incurred by the institution in the course of its business and is a key financial element because it provides the best view of the size of its programmatic activities and commitments. Because depreciation expense represents a charge to operations that reflects the future replenishment of the existing plant (and replaces the actual cash outlays for equipment and repairs formerly in the revenue and expenditures statement of private non-profit institutions under the fund accounting model), it represents a commitment of capital resources to the institution and reflects its overall operating size.

The Secretary disagrees that an institution can eliminate expenses relating to U.S. Government-sponsored scientific research programs immediately upon the termination of those programs. To the contrary, because many universities require highly specialized facilities and equipment to conduct research under those programs, they will likely incur significant upfit and other costs in re-deploying their research facilities in the event of a loss in program funding. Therefore, the Secretary considers scientific research expenditures to be an appropriate component of the operating size of an institution since the institution is committed to making those expenditures until adjustments can be made.

However, the Secretary agrees that in certain instances sponsored program expenses should be excluded from the ratio calculations. The Secretary believes that an institution that receives HEA grant program funds, especially those associated with programs that

strengthen institutions or expand access to higher education, should not fail the composite score standard solely because of the expenditure of those funds. Therefore, the amount of HEA funds that an institution reports as expenses in its Statement of Activities for a fiscal year are excluded from the ratio calculations but only if these reported expenses alone are responsible for the institution's failure to achieve a composite score of 1.5 for that fiscal year.

Changes: The Secretary eliminates the requirement proposed under § 668.172(a)(1)(ii) that a public or private non-profit institution must have a positive Primary Reserve ratio.

Proposed § 668.173(e), describing the items that are excluded from the ratio calculations, is relocated under § 668.172(c) and revised, in part, to provide that the Secretary may exclude from the ratio calculations reported expenses of HEA program funds under the conditions described previously.

Comments regarding the Viability ratio: A commenter from a non-profit institution maintained that the implicit assumption of the Viability ratio is that an institution should minimize or eliminate debt in order to preserve the accumulation of assets. The commenter opined that such a philosophy would lead to institutions avoiding the creation of revenue-creating assets, such as residence halls. Accordingly, the commenter believed that the correct measurement should be the amount of risky loans that an institution undertakes, and recommended therefore that the amount of loans secured by collateral be eliminated from the denominator of the Viability ratio.

Similarly, many commenters opined that the proposed definition of adjusted equity will discourage institutions from financing property, plant and equipment from current revenues. The commenters believed that institutions will elect instead to assume long-term debt even if the assumption of long-term debt is contrary to good business practice.

For several reasons, many commenters opposed the proposed adjustment for proprietary institutions that would limit the threshold factor for the Viability Ratio to the threshold factor for the Primary Reserve ratio in cases where the institution's Primary Reserve ratio threshold factor is a one or a two. First, these commenters maintained that such an adjustment defeats the purpose of measuring financial responsibility on the basis of three ratios. Second, the commenters argued that if the reason for this adjustment is to circumvent possible

abuse and manipulation of the Viability ratio, then there may be something wrong with using the ratio as part of the methodology. Third, the commenters argued that it is arbitrary and unfair to assume, based on the premise that the institution has manipulated its financial report, that an institution's Viability ratio will always be higher than its Primary Reserve ratio. Rather, the commenters maintained that an institution could achieve a high Viability ratio through careful financial management. The commenters recommended therefore that the Secretary use this adjustment only if the reason for using it is consistent with the concepts underlying the proposed ratio methodology. Similarly, commenters maintained that this adjustment is unfair to non-profit institutions that have no debt, because the weighting for the Primary Reserve ratio increases from 55 percent to 90 percent.

One commenter suggested that if an institution has no debt, the Secretary should allow an institution to show the amount of long-term debt that it would be able to obtain, such as, by demonstrating to the Secretary that the institution has a line of credit, or by providing to the Secretary a letter from a bank indicating the bank's willingness to make a long-term loan to the institution.

Many other commenters from the proprietary sector believed the Secretary should reward an institution that has no debt for its sound management practices, rather than penalize that institution by increasing the weighting for its Primary Reserve ratio from 20 percent to 50 percent. These commenters, and other commenters, suggested instead that for an institution that has no debt the Secretary should assign a threshold factor of 5.0 on its Viability ratio, or weight the Viability ratio at 30 percent, or both. Another commenter maintained that the amount of equity needed to achieve a strength factor score of 3.0 on the Viability Ratio is excessive and penalizes an institution for using leverage prudently. This commenter proposed that the amount of equity that results in achieving a strength factor score of 3.0 should instead yield a strength factor score of 5.0.

Another commenter suggested that an institution's Viability ratio strength factor be limited to two times the Primary Reserve strength factor in cases where the institution has a Primary Reserve strength factor score of 1.0 or 2.0. According to the commenter, this weighting scheme would allow an institution with no debt, but with a reasonable Primary Reserve ratio score,

to pass the ratio standards if it has a bad year (i.e., achieves only a strength factor score of 1.0 on the Net Income ratio). The commenter further stated that under this approach, a similarly situated institution with a Primary Reserve ratio strength factor score of 1.0 would not pass the ratio standards.

Several commenters from proprietary institutions asserted that eliminating the Viability ratio for institutions that have no debt is particularly unjust because the current acid test ratio compels institutions to remain debt-free. One of the commenters argued that the proposed adjustment to the Viability ratio acts to raise the Primary Reserve weighting for proprietary institutions to a level required of non-profits despite the real differences between these sectors. The commenter asserted that this methodology would only encourage institutions to take out debt in order to use the Viability ratio, rather than discourage that practice. The commenter suggested that if the Secretary chooses to keep this methodology, the Net Income and Primary Reserve ratios should be weighted at 80 percent and 20 percent, respectively.

Discussion: The Secretary proposed the Viability ratio because it measures one of the most basic elements of clear financial health: the availability of expendable resources (resources which can be accessed in short order) to cover debt should the institution need to settle its obligations. As such, it is useful in measuring the financial condition of most institutions. However, the Secretary has decided to remove the Viability ratio from the ratio methodology established in these regulations for the following reasons.

First, in linking the results of the Viability and Primary Reserve ratios the Secretary sought to discourage an institution from manipulating its Viability ratio by taking on a small amount of debt solely to inflate its composite score. However, linking the two ratios may result in a composite score that understates the financial health of an institution that legitimately carries a small amount of debt.

Second, based on analyses conducted by KPMG during the extended comment period of 507 audited financial statements from proprietary institutions and 395 audited financial statements from private non-profit institutions, the Secretary found that 35 percent of those proprietary institutions and 13 percent of those non-profit institutions had no long-term debt. Accordingly, the Viability ratio could not be applied to a significant number of institutions in each sector—the composite score for

those institutions would therefore be determined solely on the results of the Primary Reserve and Net Income ratios. The Secretary agrees that this was a shortcoming in the proposed methodology, and includes in the ratio methodology established by these regulations only ratios that can be applied to all institutions.

In view of the public comments, the Secretary agrees that certain aspects of the proposed methodology associated with the Viability ratio may cause, unintentionally, tensions between an institution's desire to make appropriate business decisions and the institution's compliance with the proposed regulations. Among these business decisions are those related to whether an institution should finance the cost of plant assets with external sources, or whether it should fund the cost of those investments internally with revenues from operations (or from some combination of those sources). From the analysis performed during the extended comment period, the Secretary found that some institutions chose to utilize internal resources to fund their plant assets as opposed to borrowing from external sources. For some of those institutions, that choice was a prudent business decision that is not reflected directly in either the Viability or Primary Reserve ratios. The impact of those business decisions is now reflected in the Equity ratio.

Changes: The proposed Viability ratio is replaced by the Equity ratio.

Comments regarding the numerator of the Primary Reserve and Viability ratios—Expendable Net Assets or Adjusted Equity: Commenters from non-profit institutions asserted that the numerator of the Viability and Primary Reserve ratios mistakenly neglects permanently restricted endowment net assets. The commenters maintained that revenue generated from these assets not only helps fund operations, but also helps to provide scholarships to students that generate more revenue for the institution. Some commenters believed that the Primary Reserve and Viability ratios should also include some percentage of the physical plant which is free and clear of debt, arguing that excluding physical plant from the numerators of these ratios will only encourage institutions to keep assets in cash rather than invest in physical assets that benefit students. Alternately, these commenters, and other commenters, asserted that if physical plant is not included in the numerator of the Primary Reserve ratio, then depreciation costs on physical plant should not be included in "total

expenses" of the denominator of this ratio.

Another commenter representing private non-profit institutions objected to the blanket exclusion of related party receivables from the ratio calculations. The commenter asserted that this exclusion would impact negatively many institutions that depend on church pledges, and suggested instead that the Secretary consider such factors as prior payment history and the financial strength of the related party before making a decision to exclude these receivables.

A few commenters suggested that expendable net assets exclude an institution's liability for post-retirement benefits, maintaining that this liability represents a very long-term moral obligation that will not render any institution incapable of teaching its students or discharging its obligations under the title IV, HEA programs.

Many commenters from the proprietary sector, including students, objected to the definition of "adjusted equity" as used in the numerator of the Primary Reserve and Viability ratios. The commenters asserted that excluding fixed assets (property, plant, and equipment) and intangible assets from the definition will cause institutions to forego investing in new educational equipment and educational facilities, resulting in an erosion in the quality of education students receive. Moreover, these commenters argued that the proposed treatment of equity is counterproductive because it creates a disincentive for owners to invest the resources necessary to provide quality education.

Based on the information provided by the Secretary during the extended comment period, one commenter calculated the Primary Reserve ratio for the 30 Dow Jones companies. According to the commenter, 18 of those companies would receive a strength factor score of zero, and only 9 would receive a strength factor score of 2.0 or 3.0. In order for 50 percent of these companies to achieve a strength factor score of 2.0 or 3.0, the commenter indicated that the suggested ratio score of .20 would need to be reduced to .07. From this analysis, the commenter concluded that the suggested strength factors for the Primary Reserve ratio do not appear to be reasonable and recommended that the Secretary modify the proposed definition of adjusted equity to include fixed assets.

One commenter opposed the proposed definition of adjusted equity, arguing that the definition is not explained or justified, and that it is contrary to evaluations conducted by

other agencies, such as the Securities and Exchange Commission (SEC). The commenter suggested that if the Secretary is attempting to ascertain through this definition which assets the institution holds that have value and may easily be converted to cash, then all items that result in cash flow should be included. An example of this would be that all of an institution's deferred income (reflected as a liability on the balance sheet) will not be paid in cash. In particular, the commenter maintained that many of the costs associated with an institution's recruiting activities will already have been incurred and when the deferred income is recognized on the institution's income statement as shareholder equity, the cash outlay will be less than the revenue, i.e., if the cash outlay is 55 percent of the revenue, the remaining 45 percent of the deferred income should be added to equity to arrive at the institution's adjusted equity.

Another commenter from a proprietary institution objected to the proposed definition of "adjusted equity" because it does not measure the debt capacity of an institution. This commenter suggested that the definition be changed to "net tangible assets plus unused lines of credit."

Several commenters maintained that the proposed definition of "adjusted equity" does not capture the institution's ability to adjust to periods of declining revenue, which the commenters believed is the aim of the Primary Reserve and Viability ratios.

Discussion: The Secretary disagrees with the commenters who suggested that the definition of expendable net assets mistakenly excludes permanently restricted net assets. The Primary Reserve ratio is a measure of the resources available to an institution on relatively short notice, and therefore the ratio measures only expendable net assets. Permanently restricted net assets are neither liquid or expendable, except in the event of some legal action, and therefore do not form any part of the resource measured by this ratio. The Secretary wishes to emphasize that the non-liquid resources represented by permanently restricted assets are measured by the Equity ratio.

With regard to the comment concerning the applicability of the Primary Reserve ratio to the 30 Dow Jones companies, the Secretary notes that the ratio methodology is designed to measure the elements of financial health that are appropriate for postsecondary institutions, not for manufacturing and industrial entities, which comprise most of the Dow Jones companies.

The Secretary disagrees that fixed assets should be included in adjusted equity or that plant assets should be included in the definition of expendable net assets. Because the Primary Reserve ratio provides a measure of an institution's expendable resource base in relation to its overall operating size, the logic for excluding net investment in plant is twofold. First, plant assets represent sunk costs to be used in future years by an institution to fulfill its mission—plant assets will not normally be sold to produce cash since they will presumably be needed to support on-going programs. Moreover, in some instances there is a lack of a ready market to turn the assets into cash, even if they are not needed programmatically.

Second, excluding net plant assets is necessary in identifying the expendable or relatively liquid net assets (that would be used as a component of any measure of liquid equity) available to the institution on relatively short notice. Including plant assets would distort the measure of liquid equity, and therefore would distort an important short-term measure of the institution's financial health. (The regulatory practice of excluding fixed assets is not unique to these rules. Various other regulated industries, such as depository institutions and broker dealers, are also subject to practices that exclude or limit the extent that fixed assets may comprise regulatory capital.) The Secretary notes that all tangible assets are considered by the Equity ratio.

The definition of expendable net assets excludes from those assets an institution's post-retirement benefits obligation.

The Primary Reserve ratio is not meant to capture debt or ability to borrow, but to measure the institution's expendable reserves. A measure of debt and ability to borrow is incorporated in the Equity ratio.

The Secretary disagrees that the proposed definition of "adjusted equity" does not capture an institution's ability to adjust to periods of declining revenue because the balance sheet ratios, Primary Reserve and Equity, represent the resources accumulated over time by the institution that are available to the institution to make necessary adjustments.

Changes: None.

Comments regarding the Equity ratio: Several commenters from proprietary institutions who opposed excluding fixed assets from adjusted equity (in calculating the Primary Reserve ratio) believed that this exclusion not only discourages institutions from investing in educational equipment, but rewards institutions that invest the least, i.e.,

those institutions that lease instead of purchase equipment.

Most commenters supported the suggestion made by the Secretary during the extended comment period to use an Equity ratio instead of the proposed Viability ratio. Some of these commenters believed that the use of an Equity ratio not only resolves many of the problems associated with the Viability ratio; it is also a good measure of how well an institution is capitalized and an indirect measure of an institution's ability to borrow. Moreover, these commenters opined that an Equity ratio encourages the kind of behavior that the Secretary should want to encourage—reinvestment in the institution.

Similarly, several commenters believed that the Equity ratio provides a necessary measure of capital investment, and argued that it is a better ratio than the liquidity ratio under current regulations. One of these commenters stated that liquidity ratios measure assets that can be removed fraudulently, whereas capital investment ratios measure assets that can be used to determine the owner's commitment to the institution.

Other commenters supporting the use of an Equity ratio recommended that the ratio include endowment assets in the numerator. However, some of these commenters suggested the Secretary should not raise the strength factors for the Equity ratio to compensate for the inclusion of endowment assets because this would disadvantage institutions with little or no endowments. Another commenter believed that excluding endowment assets from the Equity ratio would treat all institutions more fairly.

Discussion: The Secretary reiterates that fixed assets are not expendable assets and are thus not included in calculating the Primary Reserve ratio. However, fixed assets are included (as part of the total resources of the institution) in the Equity ratio. In providing a measure of capital resources, the Equity ratio supplements the expendable resources measured by the Primary Reserve ratio.

By comparing equity to total assets, the Equity ratio indicates the share of assets shown on the institution's balance sheet that the institution actually owns, reflecting the commitment to the institution of the owners or persons that control the institution, and provides insight into the capital structure of the institution, i.e., it indicates whether an institution has acquired a disproportionate amount of its assets utilizing debt. Excessive amounts of debt will adversely affect the

ratio and little or no debt will have the opposite effect.

The Secretary notes that Permanently Restricted Net Assets (which include the permanently restricted piece of endowment funds) are included in the numerator of the Equity ratio. However, in including those assets the Secretary did not adjust the strength factors for the Equity ratio. The strength factor values for the Equity ratio are not normalized to the relative equity of institutions in either sector; therefore inclusion of permanently restricted endowment in the calculation of the Equity ratio will help the ratio results of institutions with large endowments, but will not hurt the ratio results of institutions with little or no endowment.

Changes: The ratios described under proposed § 668.173 are relocated under § 668.172 and revised to include the Equity ratio. The Equity ratio is specifically defined for proprietary institutions under Appendix F and for private non-profit institutions under Appendix G.

Comments regarding the Net Income ratio: A few commenters believed that the proposed Net Income ratio is not fair to proprietary institutions, arguing that since the ratio is constructed and weighted in a manner that does not allow institutions that have operating losses to meet the composite score standard, those institutions would be forced to submit a letter of credit. One of these commenters asserted that operating losses sometimes occur due to changing economic circumstances (e.g., the acquisition and redevelopment of a financially-troubled institution), but that this condition is usually not a permanent feature of the institution's financial condition. Accordingly, the commenter suggested that one way of remedying this inequity would be for the Secretary to determine that an institution is financially responsible if the institution satisfies the composite score requirement for two years in a three-year cycle, or three years in a four-year cycle.

Similarly, other commenters believed that the Net Income ratio should be eliminated because it represents only the results from operations for one fiscal year but does not take into consideration prior year reserves that may be available to offset negative net income in any year.

Several commenters representing proprietary institutions asserted that institutions operating in states such as Oregon, Texas, Florida, Alaska, and Nevada that have taxes on gross receipts or property rather than on income are disadvantaged by the Net Income ratio

because taxes on gross receipts or property are always reflected as a business tax in operating expenses rather than an income tax.

Many commenters from proprietary institutions maintained that, although it is important under the proposed methodology to attain a strength factor score of at least 3.0 on the Primary Reserve ratio (so that the Viability ratio can be counted independently), attaining that strength factor requires that adjusted equity be at least 30 percent of annual expenses. The commenters argued that this strength factor was too high for several reasons. First, the commenters opined that retaining 30 percent of equity as a reserve fund creates a disincentive to invest in property and equipment. Second, the commenters stated that retaining equity rather than distributing profits to shareholders exposes a for-profit institution to an "accumulated earnings tax" of 39.6 percent on profits in excess of \$250,000, unless the institution provides a reasonable business reason for retaining the equity and a plan for its use. Under this 30 percent requirement, the commenters maintained that an institution with as little as \$833,333 in annual expenses would be exposed to the accumulated earnings tax. Third, the commenters maintained that it is very unusual for a business that is expected to provide a return on investment to retain equity exclusive of fixed assets in an amount equal to 30 percent of a year's expenses.

Similarly, several commenters representing proprietary institutions maintained that the ratios erroneously ignore differences between Chapter S and C corporations, particularly in regard to accumulated earnings tax. The commenters argued that since the treatment of owners' salaries is discretionary under both types of corporations, the proposed methodology creates an incentive for owners to manipulate their salaries (or dividends and other equity distributions) to meet the composite score. The commenters further stated that this manipulation runs afoul of income and payroll tax laws, and that regulations should not entice owners to behave in this manner. One of these commenters suggested that the Secretary define "income before taxes" as the profit before owners' salaries and distributions so that all proprietary institutions are treated in the same manner with respect to calculating the Net Income ratio.

Discussion: An institution must generate surpluses to build reserves for future program initiatives and to increase its margin against adversity. However, the Secretary accepts that

there will be circumstances where this is not possible. Therefore, the strength factors for the Net Income ratio allow an institution to earn some points toward its composite score if the institution incurs a small loss.

Regarding the comment that the Net Income ratio does not consider prior-year reserves, the Secretary reminds the commenters that those reserves are considered by the Primary Reserve and Equity ratios.

With regard to the Accumulated Earnings Tax, the Secretary would like to clarify that the only portion of stockholders' equity that is subject to the tax is retained earnings. Other components of equity such as common stock and other capital are not subject to this tax. Moreover, the Secretary believes that any potential exposure to the accumulated earnings tax on excess profits is a tax planning issue regardless of the value of the strength factors for the Primary Reserve ratio (of the 507 financial statements reviewed for proprietary institutions, the Primary Reserve ratio was 0.30 or higher for 84 or 17 percent of these institutions; of those 84 institutions, only 39 had equity (retained earnings) greater than \$250,000). These and other institutions should already be considering the potential impact of the tax, including ways to use earnings accumulated beyond the IRS limits for reasonable business needs. In any event, the Secretary notes that the changes made to the proposed methodology for other reasons minimize an institution's exposure to the accumulated earnings tax—the Viability ratio has been eliminated, and a Primary Reserve ratio result of 0.15 (as opposed to the proposed result of 0.30) is now required to earn the maximum strength factor score for that ratio.

If earnings are accumulated beyond the IRS limits, IRS regulation 26 CFR 1.537-2(b) provides some broad criteria that can be used to support the contention that earnings are being accumulated for the reasonable needs of the business, including to: (1) Provide for bona fide business expansion or plant replacement, (2) acquire a business enterprise through purchasing stock or assets, (3) provide for the retirement of bona fide indebtedness created in connection with the trade or business, (4) provide necessary working capital for the business, (5) provide for investments in or loans to customers or suppliers if necessary to maintain the business of the corporation, and (6) provide for the payment of reasonable anticipated product liability losses, an actual or potential lawsuit, the loss of a major customer, or self-insurance. A

business contingency can be considered a reasonable need if the contingency is likely to occur (e.g. flood losses in a flood prone area). The accumulation of earnings to provide against unrealistic contingencies is not considered a reasonable need.

The Secretary notes that there are several other ways to determine reasonable working capital needs, including the "Bardahl" formula. Institutions should work with their tax advisor with respect to these matters.

The Secretary disagrees that the methodology should discount Gross Receipt Tax paid by institutions in certain States because these taxes, just like other sales and property taxes that differ from State to State, are a cost of doing business.

Changes: The strength factors and weighting percentages for the Primary Reserve and Net Income ratios are revised (see Analysis of Comments and Changes, Parts 6-7).

Comments regarding the market value of assets: A commenter from a non-profit institution noted that the Viability ratio ignores the market value of assets (assets are booked at cost for balance sheet presentations), but that lenders look to market values when considering collateral to secure long-term debt. Consequently, the commenter argued that an institution's ability to borrow in order to liquidate or restructure debt may be a better measure of financial viability than an institution's ability to liquidate long-term debt from expendable resources.

Similarly, several commenters from proprietary institutions maintained that since the proposed ratio methodology does not consider the market value of real estate, it depresses the financial score of an institution that holds valuable properties, particularly if those properties have been depreciated over a long period of time. One commenter argued that this is evidenced by the fact that the commenter's institution was rated "good" by Dun and Bradstreet as of June 30, 1995, and passes the current financial responsibility standards under § 668.15, but would fail the proposed ratio standards. The commenter suggested that this problem could be solved either by allowing the institution to credit back the difference between the net book value of the property and the secured debt (mortgage), or allow the institution to provide and include as an asset the amount of the property's appraised value as certified by an appraiser. A few commenters suggested that the term "expendable net assets" include at least the book value (if not the market value) of property, plant, and equipment, arguing that it is unrealistic

to assume that these assets are valueless or incapable of being liquidated.

Discussion: The Secretary has decided not to consider the market value of property, plant, and equipment because accepting the market value of those assets would introduce a significant amount of subjectivity into the ratio calculations—the appraised value of those assets may differ depending on the person making the appraisal and the method by which that appraisal is made (such as future cash flows or comparable sales). In addition, the ratio methodology would favor unfairly an institution that chose to bear appraisal costs over an institution that did not similarly do so.

Changes: None.

Comments regarding second-tier and trend analysis: Several commenters suggested that the Secretary perform a "second-tier analysis" or use trend data to determine whether an institution that fails to achieve the required composite score is nevertheless financially responsible.

Other commenters believed that trend analysis is more revealing than the proposed one-year snapshot of an institution's financial health and suggested that the Secretary require that CPAs include that analysis as part of the institution's audited statements. One of these commenters stated that since trend data is available to an institution's current CPA, the CPA could add a footnote to the financial statement that contained the required ratio results for the institution's three most current fiscal years, as well as an average for that three-year period.

Another commenter argued that the proposed ratio methodology is useless because it employs hybrid ratios that cannot be benchmarked. This commenter proposed instead that the standards consist of a liquidity ratio, a trend analysis of cash flows from operations, and a different, better defined income ratio.

One commenter believed that the proposed methodology should be discarded in favor of more easily constructed measures, including a three-year averaged adjusted current ratio of 1:1 that would compare tangible current assets with adjusted current liabilities and a five- to ten-year trend analysis of cash flows from operations.

Discussion: In addition to the ratios suggested by the commenters previously discussed under this Part, the Secretary considered other ratios (Age of Plant, Cash Income, Secondary Reserve, and Debt to Total Assets) that could be used as secondary measures.

The Secretary did not adopt these ratios because, like the ratios suggested

by the commenters, they measure financial health more narrowly than the Primary Reserve, Equity, and Net Income ratios. Moreover, the Secretary believes that these ratios do not provide significant additional insight with respect to evaluating the financial health of an institution that would warrant their inclusion in the methodology.

Although the Secretary believes that trend analysis could be a useful approach or consideration in determining whether an institution is financially responsible, historical data regarding the ratios and the ratio methodology must first be obtained and analyzed before promulgating regulations.

Changes: None.

Comments regarding extraordinary gains and losses: Several commenters representing the proprietary sector opposed the proposal under which the Secretary may exercise discretion in determining whether an institution is financially responsible. Under this proposal, the Secretary may decide to exclude extraordinary gains and losses, income or losses from discontinued operations, prior period adjustments, and the cumulative effects of changes in accounting principles. The commenters argued that the uncertainty inherent in this proposal would make it difficult for an institution to calculate the ratios (preventing the institution from determining its regulatory status), and to develop a plan to compensate for a treatment that may exclude these items. Moreover, the commenters believed that if some institutions are favored by this discretionary treatment, public confidence in the fairness of the proposed methodology would be eroded. For these reasons, the commenters suggested that the proposal be amended by eliminating the Secretary's discretion in favor of excluding these items for all institutions.

Discussion: The commenters are correct that extraordinary gains and losses, income or losses from discontinued operations, prior period adjustments, and the cumulative effects of changes in accounting principles, should be excluded from the calculation of the Net Income ratio because these items are generally non-recurring and do not reflect the institution's continuing operations. The Secretary notes that these items are generally excluded from the ratio calculations.

The commenters are also correct in arguing that the ratio methodology should treat all institutions fairly with respect to these items, and that is the basis for the Secretary's discretion. It

has been the Secretary's experience that certain institutions do not present these items in accordance with GAAP or employ questionable accounting treatments that beneficially distort their financial condition. Consequently, the Secretary retains the discretion to include or exclude these items, or include or exclude the effects of questionable accounting treatments.

Changes: The items that the Secretary may exclude from the ratio calculations proposed under § 668.173(e) are relocated under § 668.172(c) and revised to provide that the Secretary generally excludes extraordinary gains or losses, income or losses from discontinued operations, prior period adjustments, the cumulative effect of changes in accounting principles, and the effect of changes in accounting estimates. This section is also revised to provide that the Secretary may include or exclude the effects of questionable accounting treatments.

Comments regarding unsecured related party receivables and intangible assets: Several commenters maintained that because GAAP requires that an asset possess value before it can be included in a financial statement, the Secretary improperly excludes all unsecured related party receivables on the assumption that those receivables have no value. The commenters believed that in order to obtain a complete and accurate picture of an institution's cash flow, and thus financial condition, the Secretary must change the definition of "adjusted equity" to include intangible assets, unsecured related party receivables, and fixed assets that the institution's independent auditor determines have value and liquidity. The commenters suggested that adjusted equity include at least the following: (1) Fixed assets and intangible assets that the institution's CPA determines to have value and liquidity, and (2) unsecured related party receivables, if the related party co-signs the institution's Program Participation Agreement and satisfies the same financial ratios required of the institution.

Other commenters suggested that equity be defined in accordance with the FASB pronouncement, "Accounting for the Impairment of Long-Lived Assets", maintaining that all authoritative accounting pronouncements must be taken into account in preparing financial statements under GAAP.

Several commenters argued that excluding intangible assets disregards accounting conventions used when acquisitions occur.

A commenter asserted that the definition of intangible assets contained in Accounting Principles Board (APB) Opinion No. 17 is too vague to be useful, and that the final rules should include a clarification of the term, specifically as it relates to deferred tax benefits, deferred direct response advertising costs, deferred enrollment expenses, and prepaid expenses.

A few commenters responding to the alternative set forth by the Secretary during the extended comment period for dealing with intangible assets—that intangibles could either be excluded from the calculation of the Equity ratio or that the strength factors for the Equity ratio could be increased to compensate for including intangibles—generally preferred to exclude intangibles because this alternative would disadvantage fewer institutions. One of these commenters suggested, however, that the Secretary include intangible assets but not increase the strength factors in cases where those assets are less than 10 percent of shareholders' equity. Another commenter suggested that the Secretary include in the calculation of the ratios a portion of intangible assets but require that an institution amortize those assets over a limited period, for example eight years.

Other commenters from proprietary institutions believed that the Secretary should exclude intangible assets because of the difficulties in valuing those assets.

Discussion: The Secretary uses the term "intangible assets" with the same meaning as the definition contained in APB Opinion No. 17, Intangible Assets, and disagrees that this definition is unsuitable for regulatory purposes. That definition, which may not be all inclusive, includes specifically identifiable intangibles, i.e., patents, franchises, and trademarks. The definition also includes the most common intangible asset, goodwill. "Goodwill" is the common name used to describe the excess of the cost of an acquired enterprise over the sum of identifiable net assets. The Secretary notes that items such as deferred tax assets and liabilities, deferred enrollment expenses, deferred direct response advertising costs and prepaid expenses do not meet the definition of an intangible asset in accordance with the definition in APB Opinion No. 17.

The Secretary does not agree that intangible assets should be included in the calculation of the ratios, because those assets generally represent amounts that are not readily available to meet obligations. In addition, the Secretary believes that including those assets would inject a very subjective element

into the ratio calculations, leading to an evaluation of financial health that would be arbitrary, or that could overstate significantly the financial health of an institution. Although amounts on financial statements are estimates to varying degrees, goodwill valuation is particularly subjective. In reviewing the financial statements of the proprietary sector, the Secretary found that the two most common intangibles were goodwill (excess purchase price over the fair value of assets purchased) and covenants not to compete. Clearly there is no established market for those assets and assigning a value to those assets for purposes of determining financial responsibility would be subjective at best. Moreover, there is the problem of the nature of the asset itself—it is highly unlikely that an institution could sell intangible assets to meet its general obligations. If an institution finds itself in need of liquidating assets during its normal business cycle to meet obligations, an asset such as goodwill is likely impaired. Also, in reviewing financial standards for other industries like banking and securities, the Secretary found that removing intangibles when calculating regulatory equity is a generally accepted practice.

With regard to unsecured related party receivables, the empirical data show that these receivables occur mainly in the proprietary sector where an institution is one entity in a commonly-controlled business group. Generally, unsecured related party receivables result from various intercompany transactions including shifting cash from one entity to another in the form of advances, intercompany sales for goods and services, or through more formal borrowing arrangements. Because the control over the repayment of the transaction usually lies completely with the "owners" of the business group, the receivable has little or no value to the institution whose financial responsibility is being evaluated. Also, in an administrative proceeding, unsecured or uncollateralized related party receivables are not recognized by the judge as assets available to satisfy the obligations of an institution. For these reasons, the Secretary excludes these receivables from the ratio calculations.

With regard to the commenters from private colleges and universities who objected to the blanket exclusion of related party receivables from the ratio calculations, these commenters are likely referring to annual pledges from churches or other benefactors, and not to related party receivables as defined under GAAP. On this matter, the

Secretary follows the guidance of FASB Statement 116, which prescribes criteria for recording pledges (unconditional promises to give) in the financial statements of colleges and universities as net contributions receivable. The Statement defines the term "promise to give" using the common meaning of the word promise—a written or oral agreement to do (or not to do) something. A promise to give is a written or oral agreement to contribute cash or other assets to another entity. A promise carries rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. The making or receiving of an unconditional promise to give is an event that, like other contributions, meets the fundamental recognition criteria. The Secretary will include these assets (such as pledges from church related organizations, community foundations, and trust funds) in the calculation of the numerators of the Primary Reserve and Equity ratios if they meet these requirements as set forth under FASB 116 and are recorded as an economic resource in an institution's audited financial statements.

With regard to deferred marketing costs, the Secretary is concerned that institutions that record deferred direct response advertising costs as an asset are not always following the letter or spirit of the published guidance on this subject. The Secretary has experienced significant abuses with regard to recording those costs—institutions are listing items as assets that do not meet the criteria in the Accounting Standards Division—Statement of Position (SOP) 93-7, Reporting on Advertising Costs. In instances where the Secretary determines that abuses are occurring the Secretary will exclude those assets from the ratio calculations.

With respect to deferred direct response advertising costs, the Secretary will specifically determine whether (1) the primary purpose of the advertising is to elicit sales to customers who have responded to that advertising, and (2) that advertising results in probable future benefits.

Specific documentation that the Secretary may request with respect to the first item includes the following:

- (1) Files indicating the customer names and the related direct-response advertisement;
- (2) A coded order form, coupon or response card, included with an advertisement, indicating the customer's name; and

(3) A log of customers who have made phone calls to a number appearing in an advertisement, linking those calls to the advertisement.

The Secretary also reminds institutions that the conditions in SOP 93-7 must be met in order to report the costs of direct-response advertising as assets. The Secretary believes that those conditions are narrow because it is generally difficult to determine the probable future benefits of the advertising with the degree of reliability sufficient to report related costs as deferred assets.

Changes: None.

Part 6. Comments Regarding the Proposed Strength Factors

Comments regarding the scoring process: Several commenters maintained that the proposed ratio methodology is flawed because slight changes in a single factor could create an unusual variance in an institution's composite score.

Other commenters noted that an institution could automatically receive a strength factor score of 1.0 on all its ratios regardless of its financial condition, and questioned this procedure given that it would equate institutions that have a net loss or deficit with institutions that are profitable and have positive equity.

Several commenters were concerned that the media would use the composite scores of institutions in frivolous and very misleading ways such as ranking institutions by those scores.

Discussion: The Secretary agrees that under the proposed methodology a minor difference in a ratio result could disproportionately affect an institution's composite score. For example, a proprietary institution with a Primary Reserve ratio result of 0.29 would be assigned a strength factor score of 2.0, whereas another institution with only a marginally better ratio result of 0.30 would be assigned a higher strength factor, 3.0. Assuming that all other factors are equal, the latter institution would receive a higher composite score even though the ratio results of both institutions are essentially the same. In addition, because the proposed strength factors represent a range of ratio results, a proprietary institution with a Primary Reserve ratio result of 0.30 would be assigned the same strength factor as an institution with a higher ratio result, 0.49. To eliminate the effects of differences in ratio results, the Secretary establishes in these regulations linear algorithms under which a strength factor score is calculated based on an institution's actual ratio result. For example, the strength factor score for a

proprietary institution with a Primary Reserve ratio result of 0.15 is calculated by multiplying that ratio result by a constant, using the algorithm $0.15 \times 20 = 3.0$.

The Secretary also agrees that the proposed procedure of assigning a strength factor score of 1.0 for negative ratio results does not differentiate sufficiently the financial health of institutions on the lower end of the scoring scale. In addition, the Secretary believes that for the purpose of these regulations, it is not necessary to differentiate greatly among institutions at the higher end of the scale. Therefore, in keeping with the methodology's design objective that an institution must demonstrate strength in one aspect of financial health to compensate for a weakness in another aspect and to provide greater differentiation among institutions on the lower end of the scale, the Secretary establishes in these regulations a scoring scale of negative 1.0 to positive 3.0.

In developing the strength factor scores for each of the ratios along this scale, the Secretary considered an institution's ability to satisfy its mission objectives relating to technology, capital replacement, human capital, and program initiatives. Specifically, the strength factor score reflects the extent to which an institution has the financial resources to:

- (1) Replace existing technology with newer technology;
- (2) Replace physical capital that wears out over time;
- (3) Recruit, retain, and re-train faculty and staff (human capital); and
- (4) Develop new programs.

The Secretary acknowledges that the importance of satisfying these objectives varies from institution to institution but believes that an institution must satisfy these objectives over time, not only to demonstrate that it has the financial resources necessary to provide the education and services for which its students contract, but also to meet the changing needs of its students and the demands of the marketplace.

The Secretary wishes to emphasize that the methodology measures only the financial ability of an institution to carry out these objectives. The methodology does not, nor is it intended to, assess the quality of an institution's educational programs or facilities; such quality assessments are made by the institution's accrediting agency.

Changes: The procedures for calculating the composite score proposed under § 668.173(a) are revised and relocated under § 668.172(a) to provide for the calculation of the strength factor scores. In addition,

proposed Appendix F is revised and supplemented by a new Appendix G, to reflect a scoring scale from negative 1.0 to positive 3.0, and to incorporate the linear algorithms used to calculate the strength factor scores for each of the ratios.

Comments regarding the strength factors:

Primary Reserve ratio: Several commenters believed that the required ratio results associated with the strength factors should be lowered for proprietary institutions to reflect the shorter programs offered by those institutions, arguing that since the ratio appears to gauge an institution's financial ability to complete a program, fewer resources are needed to ensure the completion of short programs.

One commenter opined that the ratio values underlying the Primary Reserve ratio strength factors for proprietary institutions are too high, noting that none of the large proprietary corporations he surveyed maintained adjusted equity equal to 30 percent of their total year expenses. The commenter argued that as the strength factor levels for this ratio are unfairly comparable to those proposed for non-profit institutions, the Secretary should adjust the proprietary sector strength factors as follows:

Ratio result	Strength factor
.05 or less	1
.06-.14	2
.15-.24	3
.25-.34	4
.35 or more	5

Another commenter also recommended that the Secretary revise the Primary Reserve ratio strength factors as indicated previously, arguing that the proposed factors penalize any institution that chooses to invest in property and equipment.

Another commenter from a proprietary institution argued that since the Primary Reserve ratio does not consider the timing of expenses or the differences between variable and fixed expenses, the ratio is difficult to value (it overlooks too many variables, such as normal business cycles for fixed expenses, and the ability of institutions to forego variable expenses during times of fiscal distress). The commenter suggested that if the Secretary establishes a Primary Reserve ratio in final regulations, the middle range of the strength factors for this ratio should reflect about 60-90 days of expenses, or about 17-25 percent of total annual expenses.

Equity ratio: Several commenters from proprietary institutions maintained that the proposed ratio standards do not recognize unused lines of credit or other direct measures of ability to borrow. One commenter suggested that such a measure should be constructed by comparing fixed assets to long-term debt, with strength factors as follows:

Ratio result	Strength factor
0.0-0.18	1
0.19-0.39	2
0.40-0.59	3
0.60-0.79	4
>0.79	5

Another commenter maintained that the suggested Equity ratio should be amended to include such a measure.

One commenter from a proprietary institution maintained that the strength factors for the Equity ratio should be set by considering an acceptable ratio of long-term assets to long-term liabilities. The commenter argued that an institution that is growing will expend its asset base in advance of recording income generated by those assets. According to the commenter, assuming a current ratio of 1:1, a ratio of long-term assets to long-term liabilities should have the following strength factors:

Ratio result	Strength factor
0.0	0
.10	1
.20	2
.25	3

Net Income ratio: Many commenters from the proprietary sector believed that the proposed strength factors for the Net Income ratio are too high. Several of these commenters opined that the emphasis placed on profitability under the proposed methodology might tempt institutions to raise tuition and cut back on educational outlays, thus shortchanging students and lowering the quality of education.

Several commenters from the proprietary sector objected to the Net Income ratio, arguing that it would discourage institutions from investing in property, plant, and equipment because it measures net income after depreciation. The commenters suggested two alternatives: (1) Retaining the proposed strength factors but reconstructing the ratio so that it is based on operating profit; or (2) retaining the proposed ratio but adjusting the strength factors.

One commenter from a proprietary institution stated that certain accrediting agencies take a strong stance

against profits in excess of five percent. The commenter suggested therefore that the Secretary take this into account in establishing strength factors for the Net Income ratio.

Although several commenters agreed that the strength factors for proprietary institutions should be higher than those for non-profit institutions to take taxes into account, the commenters believed that the difference in the proposed strength factors between these sectors is excessive. Assuming a tax rate of 40 percent, the commenters suggested that comparable and fairer strength factors for proprietary institutions should be set at 166 percent of those for non-profit institutions. Under this suggestion, the resulting strength factors would be:

Ratio result	Strength factor
<0	1
0-.0166	2
0.0167-.049	3
0.050-.082	4
>0.082	5

Another commenter argued that the strength factors for the Net Income ratio for proprietary institutions should be set at 3.0 for a five percent profit level, and the rest of the range set as follows:

Ratio result	Strength factor
<.02	1
0.02-.035	2
0.036-.05	3
0.051-.075	4
>.075	5

One commenter suggested the following strength factors, opining that the proposed strength factors penalize an institution that returns some of its operating profit to students (by providing better qualified faculty and updated teaching tools and equipment, and increasing student services):

Ratio result	Strength factor
<0	1
0-.017	2
0.018-.049	3
0.050-.082	4
>.082	5

A commenter suggested that the Secretary establish a strength factor score of 3.0 for a net income ratio of .03, to reflect the amount of State and Federal income taxes an institution must pay.

Another commenter from a proprietary institution argued that a low profit percentage does not necessarily indicate financial weakness since

income tends to be lower for a financially healthy institution during periods of expansion. Accordingly, the commenter suggested the following strength factors:

Ratio result	Strength factor
<0.0	1
0.0-.015	2
>0.015	3

One commenter recommended that the Secretary establish equal strength factor levels for proprietaries and non-profits, amend the numerator of the ratio for proprietaries to "Income After Taxes", and impute the taxes for proprietary institutions that are Subchapter S corporations or partnerships.

Discussion: The Secretary thanks the commenters for their suggestions regarding the proposed strength factors. In view of these comments, other comments regarding the proposed ratios, and the analysis performed by KPMG during the extended comment period, the Secretary revises the proposed strength factors.

In developing the strength factor scores for each of the ratios, the Secretary started by selecting critical points along the scoring scale and determining the appropriate value (ratio result) for each of those points. For example, a strength factor score of 1.0 represents the lowest ratio result that the Secretary believes an institution must achieve to continue operations, absent any adverse economic conditions. With respect to the Net Income ratio, a strength factor score of 1.0 equates to a ratio result of zero—the point where an institution just barely operated within its means. At this point, the institution broke even on an accrual basis, but it did not add to or subtract from its overall wealth. Moving down the scale, a strength factor score of zero indicates that the institution may have generated sufficient cash to meet its operating expenses, but, on an accrual basis, the institution incurred a loss. On the upper end of the scale, a strength factor score of 3.0 indicates that the institution not only operated within its means, but that it added to its overall wealth. The Secretary then drew a line that best fit those values, resulting in the linear algorithms.

Strength factor scores for the Primary Reserve ratio: The strength factor score for the Primary Reserve ratio for a proprietary institution is calculated using the following algorithm:

Strength factor score = 20 × Primary Reserve ratio result. The strength factor score for the Primary Reserve ratio for a private non-profit institution is

calculated using the following algorithm:

Strength factor score = 10 × Primary Reserve ratio result. The charts below show the strength factor scores for specific Primary Reserve ratio results.

PRIMARY RESERVE RATIOS' STRENGTH FACTOR SCORES FOR PROPRIETARY INSTITUTIONS

A Ratio Result of	Algorithm (20 X Ratio Result)	Equals a Strength Factor Score of
-.05 or less	20 X (-.05) ...	-1.0
0	20 X 0	0
.05	20 X .05	1.0
.075	20 X .075	1.5
.15 or greater	20 X .15	3.0

PRIMARY RESERVE RATIOS' STRENGTH FACTOR SCORES FOR PRIVATE NONPROFIT INSTITUTIONS

A Ratio Result of	Algorithm (10 X Ratio Result)	Equals a Strength Factor Score of
-.10 or less	10 X -.10	-1.0
0	10 X 0	0
.10	10 X .10	1.0
.15	10 X .15	1.5
.30 or more	10 X .30	3.0

As illustrated in the charts, for any strength factor score, the Primary Reserve ratio result is twice as high for a non-profit institution as it is for a proprietary institution. There are two reasons for this difference.

First, proprietary institutions generally have shorter business cycles than non-profit institutions, i.e., a proprietary institution generally has new classes starting throughout the year whereas a non-profit institution typically has only two to four starts (semesters or quarters) each year. Because of these shorter business cycles proprietary institutions are generally not as dependent on reserves of liquid assets (as measured by Primary Reserve ratio) since they can rely more on tuition revenues for necessary liquidity. In comparison, non-profit institutions must generally maintain greater amounts of liquid resources to fund short-term operations because of the longer period of time between receipt of new revenues.

Second, proprietary institutions should generally be able to obtain additional capital more quickly than non-profit institutions because owners, unlike trustees, are free to invest cash as needed to support operations and owners may increase expendable resources by leaving earnings in the institution. On the other hand, non-profit institutions are generally dependent on contributions from donors as their primary source of additional capital.

Discussion of Strength Factor Scores for the Primary Reserve Ratio

Strength factor score of 1.0: A strength factor score of 1.0 indicates that an institution has very little margin against adversity. For a proprietary institution, expendable resources equal only five percent of its total expenses (stated another way, the institution has about 18 days worth of resources that can be liquidated in the short-term to cover current operations). For a non-profit institution, expendable resources equal only 10 percent of its total expenses (the institution has about 37 days worth of resources that can be liquidated in the short-term to cover current operations).

At this level of expendable resources, the Secretary believes that an institution may be able to make payroll and meet existing obligations, but it will have difficulty financing any of its mission objectives. With respect to the fundamental elements of financial health, a strength factor score of 1.0 indicates relative weakness in viability and liquidity.

Strength factor score of zero: Moving down the scale, a strength factor score of zero indicates that an institution has no margin against adversity—the value of its liabilities is equal to the value of its expendable assets.

With no expendable resources, the Secretary believes that the institution will have difficulty meeting existing or future obligations without additional revenue or support, i.e., the institution is very sensitive to fluctuations in revenues or unexpected losses and will need to access shortly some resources from additional borrowing, capital infusions, or conversions from non-expendable assets to pay bills if it does not generate sufficient resources from revenues. With respect to the fundamental elements of financial health, a strength factor score of zero indicates weakness in financial viability and liquidity. Below this level, an institution receives negative points toward its composite score.

Strength factor score of negative 1.0: A strength factor score of negative 1.0 means that an institution has negative expendable resources—the value of its liabilities exceeds the value of its expendable assets.

At this level, the Secretary believes the institution will have serious difficulties satisfying existing obligations, and even more difficulties meeting any of its mission objectives. Because the institution is financing daily operations from another source, it must demonstrate some strength in that other source (revenue or ability to borrow) to earn positive points toward

its composite score. A strength factor score of negative 1.0 indicates extreme weakness in viability and liquidity.

Strength factor score of 3.0: On the other end of the scale, a strength factor score of 3.0 indicates that an institution has a healthy margin against adversity. For a proprietary institution, expendable resources are equal to 15 percent of its total expenses. The institution has about 55 days worth of resources that can be liquidated in the short-term to cover current operations—one or more class starts. For a non-profit institution, expendable resources are equal to 30 percent of its total expenses. The institution has about 110 days worth of resources that can be liquidated in the short-term to cover current operations—about one semester.

At this level of expendable resources, the Secretary believes that an institution has the resources to invest in human and physical capital and new program initiatives. The institution demonstrates strength in the fundamental elements of financial viability and liquidity.

In assessing the reasonableness of the strength factors for the Primary Reserve ratio, the Secretary compared these factors to the standards set by Moody's. Moody's, a primary bond rating agency, uses an expendable resources to operations ratio (similar to the Primary Reserve ratio) in analyzing credit worthiness. The Secretary notes that the Moody's ratio is more conservative than the Primary Reserve ratio because it considers only unrestricted net assets as expendable resources whereas the Primary Reserve ratio generally includes unrestricted net assets and temporarily restricted net assets as expendable resources. The median Moody's ratio for non-profit institutions with a bond rating of Aa is 4.58 for small institutions and 3.28 for large institutions. (As this ratio decreases, the relative financial health of the institution decreases.) The median Moody's ratio for institutions with a Baa bond rating is 0.669 for large institutions and 0.449 for small institutions. The Moody's definition of their Baa grade is: "Medium grade obligations, i.e., they are neither highly protected nor poorly secured. They lack outstanding characteristics and in fact have speculative characteristics as well." Institutions in this category represent a reasonable credit risk, but absent some other factor or set of circumstances, Moody's would not consider those institutions to be financially healthy.

The Secretary notes that while there are differences between the Moody's ratio and the Primary Reserve ratio, the Primary Reserve ratio result necessary to earn the highest strength factor (0.30 for

non-profit institutions, and 0.15 for proprietary institutions) is lower than the median standard set by Moody's for investment grade institutions (0.669 or 0.449).

The Secretary believes it is appropriate that the Primary Reserve strength factors are lower than the standards set by Moody's for two reasons. First, the ratio methodology is designed to assess an institution's financial health over the short-term (a 12- to 18-month time horizon), whereas the repayment period of the bonds being rated is generally long-term. Second, the rating agencies are assessing repayment capabilities in the normal course without abnormal events such as spending endowment funds or liquidating fixed assets.

Strength Factor Scores for the Equity Ratio

The strength factor score for the Equity ratio for both proprietary and non-profit institutions is calculated using the following algorithm:

Strength factor score = 6 × Equity ratio result.

The chart below shows the strength factor scores for specific Equity ratio results.

EQUITY RATIO

A ratio result of:	Algorithm (6 × ratio result)	Equals a strength factor score of:
-0.167 or less	6 × -0.167 ..	-1
0	6 × 0	0
0.167	6 × 0.167	1
0.250	6 × 0.250	1.5
0.50 or more	6 × 0.50	3

Discussion of Strength Factor Scores for the Equity Ratio

Strength factor score of 1.0: For a proprietary institution, a strength factor score of 1.0 indicates that the owner is just beginning to demonstrate a financial commitment to the business since the institution's assets are greater than its liabilities, but not by much. For a non-profit institution, a strength factor score of 1.0 may reflect a permanent endowment that provides some revenue or that may be drawn upon in extreme circumstances. In either case, most of the institution's assets are subject to claims of third parties—for every \$10.00 in assets, the institution has \$8.33 in liabilities. Stated another way, the institution's liabilities are five times greater than its equity.

The Secretary believes that this relatively small amount of equity indicates that the institution will have

difficulty borrowing at favorable market rates and that it has a very limited ability to meet its technology and capital replacement needs. With respect to the fundamental elements of financial health, a strength factor score of 1.0 indicates relative weakness in financial viability, ability to borrow, and capital resources.

Strength factor score of zero: Moving down the scale, an absence of equity (strength factor score of zero) provides no evidence of an owner's financial commitment to the business since there are no accumulated earnings or invested amounts beyond the institution's liabilities to third parties. For a non-profit institution, the absence of net assets indicates that there is little or no permanent endowment to draw upon in extreme circumstances.

At this level, the value of the institution's assets is equal to the value of its liabilities. Consequently, the Secretary believes that the institution will have difficulty obtaining additional financing because there may not be any assets to secure that financing. For an institution with relatively old plant assets that have been fully depreciated, zero equity implies that the institution must rely on additional revenues, including pledges or capital infusions, to build or invest in the future. For an institution with newer plant assets, zero equity implies that the institution has stretched its borrowing capacity beyond a reasonable limit. With respect to the fundamental elements of financial health, a strength factor score of zero indicates weakness in viability, ability to borrow, and capital resources. Below this level, an institution receives negative points toward its composite score.

Strength factor score of negative 1.0: A strength factor score of negative 1.0 means that the institution is virtually insolvent since its obligations to third parties are greater than the assets it has to satisfy those obligations. For every \$11.67 (or more) in liabilities, the institution has just \$10.00 in assets.

At this level, the Secretary believes that the institution has no ability or a significantly diminished ability to borrow because it has no resources, or very limited resources, to offer as collateral that are not already subject to claims of third parties. Moreover, the institution will have difficulty meeting any of its mission objectives. The institution will need to demonstrate strength in another source (profitability), or the owner will need to make a capital infusion, to earn positive points toward its composite score. With respect to the fundamental elements of financial health, a strength factor score

of negative 1.0 indicates extreme weakness in viability, ability to borrow, and capital resources.

Strength factor score of 3.0: On the upper end of the scale, a strength factor score of 3.0 provides evidence of an owner's financial commitment to the business, and for a non-profit institution, it indicates the accumulation of substantial net assets, including permanent endowment. The institution's assets are significantly greater than its liabilities—for every \$10.00 in assets the institution has \$5.00 in liabilities. Stated another way, the institution's liabilities are less than its equity.

At this level, the Secretary believes that an institution has the resources necessary to borrow significant amounts at favorable market rates, replace physical capital as needed, and fund new program initiatives. A strength factor score of 3.0 indicates strength in financial viability, ability to borrow, and capital resources.

As with the Primary Reserve ratio, the Secretary tested the reasonableness of the Equity ratio strength factor scores by comparing the scores in this case, to the data compiled by Robert Morris Associates (RMA). The Secretary notes that although RMA compiles survey data from various industries, it forms no conclusions about those industries from that data. RMA uses a total liabilities to tangible net worth ratio (total liabilities divided by (total tangible assets—total liabilities)) that is similar to the Equity ratio ((total tangible assets—total liabilities) divided by tangible assets). By using the RMA data, lending institutions and other investors can see how a particular institution's ratio result compares to industry averages.

In the RMA 1996 Annual Statement Studies, the median total liabilities to tangible net worth ratio score for colleges and universities (SIC #8221) was generally around 0.50 but went as high as 2.7 for small institutions—a 0.50 ratio result indicates that for every \$3.00 of assets, there is \$1.00 in liabilities. For SIC #8299, Services-School and Educational Services (proprietary institutions), the median was around 1.3, but went as high as 2.4—a ratio result of 1.3 indicates that for every \$1.77 of assets, there is \$1.00 in liabilities.

Although the 2 to 1 (assets to liabilities) relationship necessary to earn the highest score for the Equity ratio is slightly lower than the RMA median for proprietary institutions, 2.3 to 1 (and much lower than the RMA median for non-profit institutions, 3 to 1), the Secretary believes that the strength factor score for the Equity ratio is

reasonable for two reasons. First, the methodology is designed to differentiate more among institutions on the lower end of the scoring scale, not at the median or high end ranges. Second, the methodology measures an institution's financial health over a relatively short time horizon, 12-to-18 months, whereas users of the RMA data are evaluating the institution over a much longer time frame.

Strength Factor Scores for the Net Income Ratio

The strength factor score for the Net Income ratio for a proprietary institution is calculated using the following algorithm:

Strength factor score=1+(33.3 × Net Income ratio result). The strength factor score for the Net Income ratio for a private non-profit institution is calculated using the following algorithms:

If the Net Income ratio result is negative, the Strength factor score=1+(25 × Net Income ratio result);

If the Net income ratio result is positive, the Strength factor score=1+(50 × Net Income ratio result); or

If the Net Income ratio result is zero, the Strength factor score=1.

The charts below show the strength factor scores for specific Net Income ratio results.

NET INCOME RATIOS' STRENGTH FACTOR SCORES FOR PROPRIETARY INSTITUTIONS

A ratio result of:	Algorithm 1+(33.3×net income ratio result)	Equals a strength factor score of:
-0.06 or less	1+(33.3×-0.06)	-1.0
-0.03	1+(33.3×-0.03)	0
0.00	1+(33.3×0.00) ...	1.0
0.015	1+(33.3×0.015)	1.5
0.06 or more	1+(33.3×0.06) ...	3.0

Net Income Ratios' Strength Factor Scores for Private Non-Profit Institutions

A ratio result of:	Algorithm (see below)	Equals a strength factor score of:
-0.08 (or less).	1+(25×-0.08) ..	-1.0
-0.04	1+(25×-0.04) ..	0
0.00	If ratio equals zero, strength factor score automatically equals 1.	1.0
0.01	1+(50×0.01)	1.5

Net Income Ratios' Strength Factor Scores for Private Non-Profit Institutions—Continued

A ratio result of:	Algorithm (see below)	Equals a strength factor score of:
0.04 (or greater).	1+(50×0.04)	3.0

The Secretary is convinced by the commenters not to unduly penalize institutions that incur a small operating loss, and to maintain a more neutral position on those institutions that break even. Therefore, the Secretary allows an institution with a small operating loss to earn positive points toward its composite score by taking into account that the institution may be generating positive cash flow despite those losses.

Based on the analysis conducted by KPMG during the extended comment period, the Secretary found that, on average, three percent of the expenses for proprietary institutions related to non-cash items such as depreciation or amortization. The corresponding amount for non-profit institutions was approximately four percent. The Secretary believes that an institution should generally be able to endure three or four percent losses before being forced to rely on expendable reserves or its ability to raise additional capital or sell off any of its infrastructure to continue operations. Although the Secretary found that some institutions had significantly higher amounts of depreciation, limiting the depreciation estimate to these percentages adds a degree of conservatism to the methodology. If higher percentages were adopted, an institution would be able to incur larger operating losses (including cash losses) before receiving negative points toward its composite score. Moreover, higher depreciation estimates would have the perverse effect of rewarding an institution that incurred sizable operating losses but had little or no depreciation expense (the institution's assets may be nearly or fully depreciated, indicating technological and physical obsolescence). Therefore, the Secretary set a strength factor score of 1.0 for the Net Income ratio at the point where an institution is estimated to break even on an accrual basis, and a strength factor score of zero at the point where an institution is estimated to break even on a cash basis.

The Secretary also agrees with the commenters from the proprietary sector that the combined effect of the proposed strength factors and weighting placed

too much emphasis on the Net Income ratio. In addition, research conducted by KPMG during the extended comment period indicates that a six percent return on revenue for proprietary institutions, and a four percent return for non-profit institutions, are reasonable values for those institutions to earn the highest strength factor score for the Net Income ratio.

Industry Norms and Key Business Ratios, published by Dun & Bradstreet, indicates that the return on sales ratio (net profit after taxes divided by annual sales) for the middle quartile of comparable industries (SIC codes 82, 8243, 8244, and 8299) is three or four percent. *The Almanac of Business and Industrial Financial Ratios*, authored by Leo Troy, Ph.D., shows that similar industries' typical pre-tax profit as a percentage of net sales is between two and seven percent. As with the Moody's and RMA data discussed earlier, the information published by Dun & Bradstreet and Leo Troy is used only to test the reasonableness of the strength factor scores for the Net Income ratio.

In addition, Moody's uses a return on unrestricted net assets ratio and their literature shows that the median results for small non-profit institutions is 0.043—very close to the 0.04 Net Income ratio result needed to earn the highest strength factor score. For large non-profit institutions, the median result is 0.052. The Secretary notes that the ratio used by Moody's excludes investment gains and measures net income as a percentage of net assets, not total revenue, so it is not perfectly comparable with the Net Income ratio.

Discussion of Strength Factor Scores for the Net Income Ratio:

Strength factor score of 1.0: A strength factor score of 1.0 indicates that an institution just barely operated within its means. On an accrual basis, the institution broke even. At this level the institution is able to fund historical capital replacement costs, but is not completely providing for the future replenishment of its capital assets.

The Secretary believes that an institution needs to generate operating surpluses because, absent those surpluses, it cannot grow its margin against adversity without capital infusions or donor contributions. A strength factor score of 1.0 indicates relative weakness on the fundamental financial element of profitability.

Strength factor score of zero: Moving down the scale, a strength factor score of zero indicates that an institution did not operate within its means during its operating cycle, but may have broken even on a cash basis, i.e., the institution

may have generated sufficient cash to meet its operating expenses, but it did not fund its non-cash expenses. On an accrual basis, a proprietary institution incurred a loss equal to three percent of its total revenues, and a non-profit institution incurred a loss equal to four percent of its total revenues.

At this level, the Secretary believes that an institution is unable to fund its capital replacement costs and that it cannot continue operations for an extended time without depleting its equity. A strength factor score of zero indicates weakness on the fundamental financial element of profitability. Below this level, an institution receives negative points toward its composite score.

Strength factor score of negative 1.0: A strength factor score of negative 1.0 indicates that an institution not only did not operate within its means, but that its operations most likely produced negative cash flow since losses exceeded non-cash expenses. On an accrual basis, a proprietary institution incurred losses equal to 6 percent (or more) of its total revenues, while a non-profit institution incurred losses equal to 8 percent (or more) of its revenues.

At this level, the institution decreased its margin against adversity and continued losses will deplete its other resources. A strength factor score of negative 1.0 indicates weakness in the fundamental financial element of profitability.

Strength factor score of 3.0: On the upper end of the scale, a strength factor score of 3.0 indicates that an institution not only operated within its means, but added to its overall wealth, thus increasing its margin against adversity. On an accrual basis, a proprietary institution generated operating surpluses equal to at least six percent of its total revenues, and a non-profit institution generated surpluses equal to at least four percent of its total revenues.

At this level, the Secretary believes that the institution is not only funding its capital replacement costs, but that it has operating surpluses to invest in new program initiatives and human and physical capital. A strength factor score of 3.0 indicates strength on the fundamental financial element of profitability.

Changes: As discussed in this Part, proposed Appendix F is revised and supplemented by a new Appendix G to reflect the strength factor scores for each of the ratios, and to provide the linear algorithms used to calculate those scores.

Part 7. Comments Regarding the Weighting of the Proposed Ratios

Comments: A commenter from a proprietary institution believed that the proposed strength factor values and weighting of the Primary Reserve ratio for proprietary institutions are too low. The commenter argued that the weighting given to the Primary Reserve ratio should be at least equal to the weighting given to the Net Income ratio because the retained wealth of an institution, which can be used to weather financial difficulties, is just as important as the one-year profit earned by the institution. Accordingly, the commenter suggested that the Secretary weight the ratios as follows: 40 percent for the Primary Reserve ratio, 30 percent for the Net Income ratio, and 30 percent for the Viability ratio.

A commenter from a proprietary institution opined that if the Secretary substitutes an Equity ratio for the Viability ratio, the Secretary should weight the Equity ratio the most because it is the ratio that best measures long-term financial stability.

Commenters from proprietary institutions believed that a 50 percent weighting on the Net Income ratio placed too much emphasis on the short-term financial situation of the institution. One of these commenters suggested instead that all of the ratios should be weighted equally. Along the same lines, other commenters from proprietary institutions favored lowering the weighting of the Net Income ratio from 50 percent to 30 percent or 40 percent, while another commenter suggested that the Secretary assign the same weight to the Net Income ratio for proprietary institutions that is assigned to non-profit institutions.

Some commenters believed that the proposed weighting of the income ratio would lead to fiscal mismanagement (institutions would need to stockpile profits to meet the ratio standards) or encourage unscrupulous for-profit institutions to declare and pay out huge dividends to owners.

One commenter representing proprietary institutions appreciated the Secretary's willingness to revise the proposed ratio weights in response to public comment, but believed that the suggested revised weights moved too far in reducing the weight of the Net Income ratio and increasing the weight of the Primary Reserve ratio for proprietary institutions. The commenter asserted that because the proprietary sector consists of a variety of institutions of different sizes, structures, and management philosophies (and

must deal with a variety of different tax issues), the Secretary should place the majority of the weight on the combination of the ratios that measure financial health in the short and long-term: the Net Income and Equity ratios. The commenter suggested that an equitable weighting would be in the neighborhood of 40 percent for the Equity ratio, 40 percent for the Net Income ratio, and 20 percent for the Primary Reserve ratio.

Another commenter believed that the two most important factors for determining the financial responsibility of a proprietary institution are whether the institution is making a profit and the amount of tangible net worth the institution has available to sustain losses. Accordingly, the commenter suggested that the Secretary weight the Net Income ratio at 50 percent, the Equity ratio at 30 percent, and the Primary Reserve ratio at 20 percent. Alternatively, the commenter opined that weighting the Net Income and Equity ratios at 40 percent each would also be reasonable. The commenter believed strongly that the weighting for the Primary Reserve could be increased above 20 percent, but only if the ratio results required for the corresponding strength factors are reduced or if the Secretary modifies the definition of adjusted equity to include fixed assets.

Other commenters suggested various other weighting percentages that the Secretary should adopt for proprietary institutions, including weighting the Equity ratio at 30 percent, the Primary Reserve ratio at 20 percent, and the Net Income ratio at 50 percent.

A commenter representing private non-profit institutions argued that the Secretary should consider any institution to be financially responsible if that institution has positive expendable net assets and generates an annual surplus of revenues over expenses because such an institution does not represent a threat to Federal funds. Accordingly, the commenter recommended that the Secretary weight the Net Income ratio more heavily and in a manner that establishes the financial responsibility standard for private non-profit institutions as breaking even or running a small surplus annually. Similarly, another commenter from a private non-profit institution objected that the proposed ratio methodology weights the two balance sheet ratios (Viability and Primary Reserve) more heavily than the income statement ratio (Net Income). The commenter believed that this weighting scheme minimizes the value of strong operating results (as measured by annual changes in unrestricted net

assets), and favors unfairly institutions with substantial expendable net assets. Along the same lines, another commenter suggested that the Primary Reserve and Net Income ratios for private non-profit institutions be weighted equally.

Other commenters from the non-profit sector believed that the Primary Reserve ratio was too heavily weighted (55 percent), arguing that such a weighting would create a disincentive for institutions to invest internal funds in plant assets even if those assets were revenue producing (such as dormitories).

Discussion: The Secretary thanks the commenters for their suggestions regarding the weighting percentages.

Discussion Regarding the Relative Importance (Weighting Percentages) of each of the Ratios for Proprietary Institutions

Regarding these and other comments from proprietary institutions that the weighting percentage for the Primary Reserve ratio should not be increased from the proposed level of 20 percent, the Secretary notes that expendable resources are measured by two of the proposed ratios, Primary Reserve and Viability, that together carry a combined weight of 50 percent. The Primary Reserve ratio measures expendable resources in relation to total expenses and the Viability ratio measures expendable resources in relation to total long-term debt. Since the proposed Viability ratio has been eliminated in favor of the Equity ratio, the Secretary believes that the weighting percentage for the Primary Reserve ratio must be increased because it is the only remaining measure of an institution's expendable resources. However, the Secretary does not believe that the weighting percentage of the Primary Reserve ratio should be increased to reflect the combined weight given to expendable resources under the proposed methodology because the importance of expendable resources to proprietary institutions is somewhat mitigated for two reasons. First, since proprietary institutions have frequent class starts they can rely more on tuition revenues than on reserves of liquid assets to meet near-term needs. Second, by comparing expendable equity to debt, the Viability ratio provided a measure of an institution's ability to borrow that is now provided by the Equity ratio.

The Secretary agrees with the commenters who argued that the Primary Reserve and Equity ratios are just as or more important than the Net Income ratio because together these

balance sheet ratios reflect all of the resources accumulated over time by an institution that are available to the institution to support its current and future operations. By comparing tangible equity to tangible total assets, the Equity ratio provides a measure of the total resources that are financed by accumulated earnings and owner investments, or, stated another way, the amount of an institution's assets that are subject to claims of third parties. In so doing, the Equity ratio provides an indication of the commitment of an owner to the institution—a higher ratio indicates a greater commitment on the owner's part because a greater percentage of the owner's capital is at risk than would otherwise be the case if that institution was either highly leveraged or the owner had taken capital out of the institution. However, unlike the Primary Reserve ratio (or the Viability ratio), the Equity ratio does not provide a direct measure of the amount of resources that an institution has to meet its near-term obligations. Rather, the Equity ratio provides a high-level view of an institution's overall capitalization, and by inference its proportionate ability to borrow. Thus, the Equity ratio supplements the direct measure of the resources that an institution has available in the near-term (i.e., expendable resources measured by the Primary Reserve ratio) by providing a measure of all of the resources available to the institution to support its operations. In combination, the Primary Reserve and Equity ratios reflect the financial viability of an institution; that is, the ability of the institution to continue to achieve its operating and mission objectives over the long-term.

With regard to the weighting of the Net Income ratio, the Secretary is convinced by the commenters that in emphasizing profitability (by weighting the Net Income ratio at 50 percent), the proposed methodology may encourage proprietary institutions to cut back on necessary educational expenses or engage in other inappropriate behaviors. In addition, the Secretary agrees with these and other commenters that minor operating losses or year-to-year fluctuations in profits may not severely impair an institution from meeting its operating objectives in any particular year as long as the institution has other resources available to support its operations. For these reasons, the Secretary believes that the weighting percentage for the Net Income ratio must be reduced. However, the Net Income ratio must still carry a significant weight because operating

profits increase the institution's financial health over time and are necessary for a proprietary institution to meet one of its primary objectives—to distribute earnings to owners and shareholders.

Discussion Regarding the Relative Importance (Weighting Percentages) of Each of the Ratios for Non-Profit Institutions

The Secretary agrees that the weighting percentage for the Net Income ratio must be increased because the proposed methodology does not adequately account for strong operating performance. However, that increase must be limited because, unlike proprietary institutions, generating operating surpluses is not an objective of many non-profit institutions. In addition, accumulated operating surpluses are reflected in the Equity ratio.

The Secretary also agrees with the comments that the proposed weighting of Primary Reserve ratio (55 percent) is too high and that emphasizing the importance of expendable resources may create a disincentive for institutions to invest internal funds in necessary non-expendable assets. By using internal funds to finance the cost of plant assets, an institution's expendable resources are reduced, lowering both its Primary Reserve and Viability ratios. Because these two ratios carry a combined weight of 90 percent under the proposed methodology, a business decision to use internal funds for these purposes may substantially impact an institution's composite score. Although the Secretary believes that the weighting percentage of the Primary Reserve ratio must be reduced, it must still carry a significant weight for two reasons. First, since the operating cycles for non-profit institutions are generally tied to semesters or terms (as compared to proprietary institutions that generally have more frequent class starts), non-profit institutions must rely more on expendable reserves than on tuition revenues to meet near-term needs. Second, since the Viability ratio has been eliminated in favor of the Equity ratio that considers all of an institution's resources (including fixed assets and endowments), the impact of any reduction in expendable reserves reflected by the Viability ratio is also eliminated.

Changes: In view of this discussion, and the professional judgment of the Department and KPMG, the Secretary establishes the following weighting percentages:

Ratio	Proprietary institutions (percent)	Private non-profit institutions (percent)
Primary Reserve	30	40
Equity	40	40
Net Income	30	20

Proposed Appendix F is revised and supplemented by a new Appendix G to reflect these weighting percentages.

Part 8. Comments Regarding the Proposed Ratio Methodology as a Test of Financial Responsibility.

Comments regarding the composite score standard: Many commenters from private non-profit institutions opposed the creation of a "bright line" standard (i.e., the 1.75 composite score) based on the KPMG report. These commenters maintained that the KPMG report did not establish a test of financial responsibility, but merely recommended a screening process under which the Secretary could easily identify problem institutions. The commenters recommended that the Secretary remove the bright line standard as a test of financial responsibility and instead perform additional analyses of institutions falling below the 1.75 composite score before determining whether those institutions are financially responsible.

Several commenters from proprietary institutions maintained that the 1.75 composite score was too high, and that the Secretary should either abandon or revise the proposed methodology.

One commenter from a proprietary institution suggested that because of the uncertainty of the impact of these ratios, the Secretary should establish a three-year period of evaluation during which the composite score would be set at 1.25.

Several commenters opined that the Secretary should not conclude that an institution is not financially responsible solely because it failed to achieve a 1.75 composite score. The commenters asserted that certain occurrences, such as retirement incentive plans formulated to downsize an institution, could make it appear that the institution is not financially responsible under the proposed ratio methodology, when in fact the institution is financially healthy. The commenters suggested that the Secretary should determine that an institution is not financially responsible only if an independent auditor indicates concern about the institution's financial health in the Independent Auditor's Report or Management Letter comments.

A commenter from a proprietary institution suggested that the Secretary establish the composite score

requirement based on the following rationale: if the Secretary allows an institution that loses money to pass the composite score requirement, the institution should be allowed to pass only if it is able under the other ratios to operate for 45 days by using its equity to meet current expenses. According to the commenter, this would lead to the following set of strength factors and weightings for a passing composite score of 1.0: a Primary Reserve Ratio result of .06 would equal a strength factor score of 1.0, weighted at 20 percent; an Equity Ratio result (defined as net worth/expenses) of .125 would equal a strength factor score of 2.0, weighted at 40 percent; and a Net Income Ratio result that was negative, resulting in a strength factor score of zero, weighted at 40 percent. The commenter suggested that the absolute value of the Net Income Ratio, when negative, should be no less than 50 percent of equity in order for the institution to pass. The commenter also suggested that an institution with negative equity, or with an operating loss that is in excess of 50 percent of its net worth, should fail the ratio tests.

Discussion: With regard to the first set of comments, the Secretary acknowledges that there were differing expectations about the intended use of the methodology. However, the Secretary disagrees that the KPMG report did not provide a basis for proposing a regulatory test (the composite score standard) solely because the report did not describe how the Secretary would determine the disposition of those institutions that would not satisfy that test. The Secretary provided alternatives for those institutions as part of the proposed rule. Moreover, the methodology detailed in that report provided a measure of the financial health of institutions along a scale from which the Secretary could reasonably propose a regulatory test of financial responsibility.

The Secretary agrees with the commenters that the composite score standard under the proposed methodology is too rigorous, mainly because that methodology was designed to evaluate the financial health of an institution over a two-to four-year time horizon.

In the methodology established by these regulations, the strength factor scores and weighting percentages are revised to measure the financial health of an institution over a much shorter time horizon, 12-to-18 months, to correspond with the period that generally passes before the Secretary receives financial statements from institutions and makes financial

responsibility determinations based on those statements.

In determining the minimum value of the composite score that an institution would need to achieve to demonstrate that it is financially responsible, the Secretary sought to identify the score at which an institution should not only have some margin against adversity, but also the resources to fund to some extent its technology, capital replacement, human capital, and program needs. The Secretary understands that institutions have differing funding needs and that it may not be necessary for some institutions to fully fund those needs every year. However, the Secretary believes that for an institution to demonstrate that it has the financial ability to provide, and to continue to provide in times of fiscal distress, the education and services for which its students contract, it must over time generate or acquire the resources to adequately fund its needs and to grow, if necessary, its margin against adversity. Along these lines, the Secretary establishes a composite score standard of 1.5.

As discussed previously under Analysis of Comments and Changes, Part 6, a strength factor score of 1.0 represents the lowest ratio result that the Secretary believes an institution must achieve to continue operations, absent any adverse economic conditions. A hypothetical institution with strength factor scores of 1.0 for all of the ratios achieves a composite score of 1.0. At this level on the scoring scale, the institution has very little margin against adversity, is just barely living with its means, and most of its assets are subject to claims of third parties. Although the institution may be able to make its payroll and meet its existing obligations, it will have difficulty borrowing at favorable market rates. Moreover, because it has very limited resources, the institution will have difficulty funding its technology, capital replacement, and program needs. Moving below this level on the scoring scale, it becomes very difficult for the institution to satisfy existing obligations, and even more difficult to fund any of its technology, capital replacement, human capital, and program needs. Moving up the scale, the institution's overall financial health increases incrementally. At a composite score of 1.5, the institution operated within its means and added somewhat to its overall wealth, and has some margin against adversity. At this level, the institution is funding historical capital replacement costs and has operating surpluses to provide funding for some investment in human and

physical capital, but it has no excess funds to support new program initiatives or major infrastructure upgrades. In addition, while the institution may be able to borrow at favorable market rates, it may need to borrow to replace physical capital.

The Secretary notes that the specific financial characteristics of institutions may differ somewhat from those of this hypothetical institution, depending on the strength or weakness those institutions demonstrate in the fundamental elements of financial health. However, since the methodology measures those strengths and weaknesses along a common scale and takes into account the relative importance of the fundamental elements, the overall financial health of an institution at any given composite score is the same as that of any other institution with that composite score.

To illustrate the differences between groups of institutions scoring above and below the composite score standard, the following charts show the median value of each ratio for those institutions.

EMPIRICAL DATA FOR PROPRIETARY INSTITUTIONS, MEDIAN RATIO RESULTS

Range of composite scores	Equity ratio	Primary reserve ratio	Net income ratio
0.5 to 0.9	0.089	0.008	0.017
1.0 to 1.4 .....	.180	.038	.024
1.5 to 1.9 .....	.294	.094	.009

EMPIRICAL DATA FOR NON-PROFIT INSTITUTIONS, MEDIAN RATIO RESULTS

Range of composite scores	Equity ratio	Primary reserve ratio	Net on-come ratio
0.5 to 0.9	0.388	-0.087	-0.017
1.0 to 1.4 .....	.583	.009	-0.001
1.5 to 1.9 .....	.602	.087	.004

These ranges are selected to reflect the difference between the minimum composite score that the Secretary believes an institution must attain to continue operations (1.0) and the composite score that an institution must attain to be financially responsible (1.5). To characterize the ratio results of institutions in these ranges, the median (the value that falls in the middle of the range) was chosen as the measure of central tendency because unlike the mean or mode, the median ignores extreme values, except to account for their location with respect to the middle value of the range.

For proprietary institutions in the 0.5 to 0.9 composite score range, the median value of the Net Income ratio

indicates relative strength in one fundamental element of financial health—profitability. However, that strength is outweighed by weaknesses in the Equity and Primary Reserve ratios. In contrast, the proprietary institutions scoring in the 1.5 to 1.9 range show relative strength in the Equity and Primary Reserve ratios. These strengths in viability, liquidity, capital resources, and ability to borrow, account for 70 percent of the composite score and outweigh those institutions' relative weakness in profitability.

For non-profit institutions in the 0.5 to 0.9 composite score range, the median value for the Equity ratio indicates relative strength in ability to borrow, viability, and capital resources, but that strength is outweighed by serious weaknesses in the Primary Reserve and Net Income ratios which account for 60 percent of the composite score. In the 1.5 to 1.9 range, the positive Primary Reserve and Net Income ratios, although relatively weak, supplement those institutions' strength in the Equity ratio.

Changes: The composite score standard proposed under § 668.172(a) is relocated to § 668.171(b) and revised to provide that to be financially responsible an institution must achieve a score of at least 1.5.

Part 9. Comments Regarding Alternative Means of Demonstrating Financial Responsibility

Comments regarding the proposed precipitous closure alternative: A commenter from a higher education association believed that the Secretary should amend the proposed precipitous closure alternative by eliminating the qualifying requirement that an institution must satisfy the general standards of financial responsibility for its previous fiscal year. The commenter opined that the ratios are not short-term measures of financial health that can be corrected quickly by an institution and suggested that an institution should only have to show that its financial condition has not worsened during the year in which the institution relied on this alternative in order to use it again. The commenter reasoned that if the institution's financial health is improving, it poses less of a risk in subsequent years.

Many commenters from proprietary institutions opposed the proposed precipitous closure requirements. The commenters believed that by including personal financial guarantees, the Secretary elevated the precipitous closure standard beyond the current past performance and going concern requirements. These commenters and

many others from the non-profit sector maintained that the proposed requirement of personal financial guarantees is neither supported by, nor in keeping with, section 498(c)(3)(C) of the HEA. The commenters believed that the Secretary should retain the current alternatives described in § 668.15(d)(2) under which an institution that fails to satisfy the general standards may demonstrate that it is nevertheless financially responsible.

Many other commenters opposed the concept of requiring personal financial guarantees under any circumstances. Some commenters from non-profit institutions maintained that personal financial guarantees would be impossible to obtain from their trustees or would lead persons to refuse to serve as trustees or would create conflicts of interest for trustees. Several commenters representing proprietary institutions believed that personal financial guarantees are unfair and arbitrary, because the guarantees would expose the owners of small family businesses to the loss of personal assets, including their homes and savings.

Several other commenters recommended that instead of immediately requiring a letter of credit or personal financial guarantees from an institution that fails to achieve the composite score, the Secretary should use a longer term analysis of the institution's financial condition, including the institution's management record. These commenters believed that if an institution failed the general standards one year out of several, more extensive forms of reporting or monitoring should be required to determine whether the institution is improving (particularly when the institution's failure to meet the ratio standards results from normal fluctuations in the business cycle).

Discussion: With regard to the comment that the Secretary should eliminate the requirement that an institution must satisfy the general standards of financial responsibility for its previous fiscal year to qualify for the proposed alternative, the Secretary notes that this requirement was originally established as part of the precipitous closure exception under the financial responsibility regulations published on April 29, 1994. Under that exception an institution was not required to post a surety or enter into provisional certification to continue participating in the title IV, HEA programs. To minimize the Federal risks from unprotected participation, the Secretary structured the exception so that it was available only to an institution that (1) was financially

responsible in its fiscal year prior to the year in which it sought to qualify under the exception, (2) demonstrated that its deteriorated financial condition was not exacerbated by benefits given to owners or related parties, and (3) otherwise demonstrated, by satisfying certain conditions, that it had sufficient resources to ensure that it would not close precipitously. That structure allowed a qualifying institution one year to improve its financial condition and prevented that exception from becoming a means for the institution to continue participating under a lower standard of financial responsibility than that required of all other institutions (for more information, see 59 FR 34964-34965).

In keeping with the concept that the precipitous closure exception should provide an opportunity for a financially weak institution to improve its financial condition, but instead of requiring the institution to demonstrate that it had not engaged in certain practices that could have led to its deteriorated financial condition, the Secretary proposed that an institution would need to attain a composite score of at least 1.25 and the owners, trustees, or other persons exercising substantial control over the institution would have to provide personal financial guarantees. The proposed composite score was intended to establish a minimum threshold below which an institution's financial condition had so seriously deteriorated that additional protections, such as surety or provisional certification, would be required immediately to protect the Federal interest. For institutions scoring at or above that minimum threshold, the Secretary proposed requiring personal financial guarantees based on the reasoning that if the owner or person exercising substantial control over the institution was willing to risk the loss of his or her personal assets on behalf of the institution, the Secretary would accept the corresponding risk to the Federal interest by allowing that financially weak institution to continue to participate in the title IV, HEA programs.

In light of the comments, the Secretary acknowledges that requiring personal financial guarantees may prevent some institutions from qualifying under the proposed alternative. Moreover, the Secretary is convinced by these and other commenters that instead of immediately requiring personal financial guarantees or a surety, a more considered and less burdensome approach should be adopted for institutions that do not satisfy the composite score standard.

Along these lines, and in view of the preceding discussion, the Secretary establishes in these regulations the "zone" alternative under which a financially weak institution has up to three consecutive years to improve its financial condition without having to post a surety, provide personal financial guarantees, or participate under a provisional certification. To qualify initially under this alternative, an institution must achieve a composite score in the zone from 1.0 to 1.4, and to continue to qualify, must achieve a composite score of at least 1.0 in each of its two subsequent fiscal years. If the institution does not score at least 1.0 in one of those subsequent fiscal years or does not sufficiently improve its financial condition so that it satisfies the composite score standard (achieves a composite score of at least 1.5) by the end of the three-year period, the institution must satisfy another alternate standard under these regulations to continue to participate in the title IV, HEA programs. However, the institution may qualify again under the zone alternative for its fiscal year following the next fiscal year in which it achieves a composite score of at least 1.5.

The zone alternative is not available to an institution scoring below 1.0 because there is considerable uncertainty regarding the ability of the institution to continue operations and satisfy its obligations to students and to the Secretary. For that institution, the Secretary believes that additional oversight and surety are required immediately to protect the Federal interest.

On the other hand, an institution scoring in the zone should generally be able to continue operations for the next 12-to-18 months, absent any adverse economic event. However, because of that institution's limited ability to deal with adversity and its overall weak financial condition, the Secretary believes it is necessary to monitor more closely the operations of that institution, including its administration of title IV, HEA program funds. Accordingly, under the zone alternative the Secretary requires an institution to provide timely information regarding certain oversight and financial events that may adversely impact the institution's financial condition, but that the Secretary would not generally become aware of until six months after the end of the institution's fiscal year when that institution submits its audited compliance and financial statements. The following chart compares the proposed precipitous closure alternative to the zone alternative.

Provision	Proposed precipitous closure alternative, § 668.174(a)(3)	Zone alternative, § 668.175(d)
To qualify initially under the alternative, an institution must.	1. Achieve a composite score of 1.25 to 1.74 (on a scale from 1.0 to 5.0); 2. Satisfy all of the general standards of financial responsibility for its previous fiscal year; 3. Provide personal financial guarantees from owners, board of trustees, or other persons exercising substantial control over institution; and 4. Demonstrate to the Secretary that it will not close precipitously.	1. Achieve a composite score of 1.0 to 1.4 (on a scale from negative 1.0 to positive 3.0). <i>Informational and Administrative Procedures</i> Rather than having to satisfy the qualifying requirements under the proposed precipitous closure alternative, an institution must provide information regarding certain oversight and financial events and comply with cash management and other provisions.
To continue to qualify, an institution must.	Not available; an institution could qualify under this alternative for only one year.	Achieve a composite score no less than 1.0 in each of its next two years under the alternative and continue to comply with the <i>Informational and Administrative Procedures</i> above.
Institution may qualify again under the alternative.	For its fiscal year following the year that it satisfies the composite score standard (1.75).	For its fiscal year following the next year that it satisfies the composite score standard (1.5 or greater).

With regard to the reporting requirements under the zone alternative, an institution must provide information to the Secretary no later than 10 days after the following events occur: (1) Any adverse action taken against it by its accrediting agency, (2) any event that causes the institution, or related entity, to realize any liability that was noted as a contingent liability in the institution's or related entity's most recent audited financial statements, (3) any violation by the institution of any existing loan agreement, (4) any failure of the institution to make a payment in accordance with its existing debt obligations that results in a creditor filing suit to recover funds under those obligations, (5) any withdrawal of owner's equity from the institution by any means, including by declaring a dividend, or (6) any extraordinary losses.

In addition, the Secretary may, on a case-by-case basis, require an institution to submit its compliance and financial statement audits earlier than six months after the end of its fiscal year or provide information about its current operations and future plans.

With regard to administering title IV, HEA program funds, the Secretary is mindful of the concerns raised by commenters about the onerous nature of the reimbursement payment method. Therefore, the Secretary amends the Cash Management regulations under subpart K to include a new payment method, cash monitoring, that is in several respects similar to reimbursement but much less onerous. Like the reimbursement payment method, an institution under the cash monitoring payment method must first make disbursements to eligible students and parents before the Secretary provides title IV, HEA program funds to the institution for the amount of those disbursements.

However, under cash monitoring, the Secretary (1) allows the institution itself to make a draw of title IV, HEA program funds for the amount of the disbursements the institution has made to eligible students and parents, or (2) reimburses the institution for those disbursements based on a modified and more streamlined review and approval process. For example, instead of requiring the institution to provide specific documentation for each student to whom the institution made a disbursement, and reviewing that documentation before providing funds to the institution, the Secretary may simply require the institution to identify those students and their respective disbursement amounts and provide title IV, HEA program funds to the institution based solely on that information. The Secretary further amends subpart K to provide that an institution that is placed under the cash monitoring payment method is subject to the disbursement and certification provisions that apply to FFEL Program funds, but in keeping with the nature of cash monitoring, the Secretary may modify those provisions.

For an institution that qualifies under the zone alternative, the Secretary determines whether to provide title IV, HEA program funds to the institution under one of the cash monitoring payment options or by reimbursement. As part of its compliance audit, an institution must require its auditor to express an opinion on its compliance with the requirements under the zone alternative, including its administration of the payment method under which the institution received and disbursed title IV, HEA program funds. If an institution fails to comply with the information reporting or payment method requirements, the Secretary may determine that the institution no longer qualifies under this alternative.

Finally, with respect to the other comments regarding personal financial guarantees, the Secretary would like to clarify that under section 498(e) of the HEA the Secretary may require these guarantees from an institution with past performance problems or from an institution that fails, or has failed in the preceding five years, to satisfy the general standards of financial responsibility.

Changes: The precipitous closure alternative proposed under § 668.174(a)(3) is replaced by the zone alternative. The zone alternative is located under § 668.175(d) of these regulations.

The Cash Management regulations under subpart K are revised in several ways. First, § 668.162(a)(1) is amended to include cash monitoring as a payment method under which the Secretary may provide title IV, HEA program funds to an institution. Second, a new paragraph (e) is added to § 668.162 that sets forth the provisions of the cash monitoring payment method. Lastly, a new paragraph (f) is added to § 668.167 to provide that the Secretary may require an institution under the cash monitoring payment method to comply with the disbursement and certification provisions that apply to institutions placed under the reimbursement payment method. This paragraph also provides that the Secretary may modify those disbursement and certification procedures for institutions under cash monitoring.

The provisional certification alternatives proposed under § 668.178 (b) through (d) are relocated under § 668.175 (f) and (g) and revised to clarify when and the conditions under which the Secretary may require an institution, or the persons who exercise substantial control over the institution, to provide personal financial guarantees. Also, these sections are amended by removing the proposed

requirement that an institution must demonstrate that it will not close precipitously and providing in place of that requirement that an institution must comply with the zone provisions under § 668.175 (d)(2) and (3).

Comments regarding the irrevocable letter of credit alternative: Many commenters maintained that the proposed rules continue to contradict statutory language in specifying that letters of credit be for one-half of all annual title IV, HEA disbursements, rather than for one-half of potential annual liabilities.

A commenter representing private non-profit institutions asserted that the letter of credit alternative was not feasible for small, frugal, tuition-driven institutions. The commenter suggested that the Secretary should not require these institutions to provide letters of credit unless the institutions have audit or program review liabilities.

Many commenters contended that providing a letter of credit payable to the Secretary erodes an institution's financial condition, affects negatively an institution's ability to provide educational services, and could lead to the precipitous closure of an institution that would otherwise have continued operations. One of these commenters reasoned that this provision is counter-intuitive—an institution that could afford to secure a letter of credit would not need to because it would probably pass the ratio standards, but an institution that did not pass the ratio standards probably could not afford to secure the letter of credit.

Similarly, another commenter recommended that in cases where institutions fail to meet the composite score standard for one year, the Secretary should adopt an accrediting agency approach and work with those institutions by helping them create a formal recovery plan instead of imposing letter of credit requirements that would weaken those institutions' financial condition.

Several commenters from the proprietary sector suggested that the Secretary expand the alternative methods of demonstrating financial responsibility for small institutions to include a provision under which those institutions could provide a letter of credit in the amount of five percent or 10 percent of their prior-year title IV, HEA program funds. The commenters stated that this alternative would be more equitable because a small institution may not be able to afford the cost of obtaining a large letter of credit, or have available sufficiently large credit lines to secure a 50 percent letter of credit. The commenters also

recommended that for all institutions, an alternative should be the provision of a letter of credit in an amount ranging from five percent to 50 percent of the institution's prior-year title IV funds, tied to the perceived shortfall in funds, or to the operating loss that triggered the institution's failure to meet the standards.

Discussion: The Secretary continues to believe that the practice of equating the institution's potential liabilities with the amount of funds received during a prior year is reasonable, especially since the law takes into consideration the value of potential loan discharges and unpaid student refunds. The thresholds used to measure financial responsibility, and to establish appropriate minimum surety levels, do not take into consideration additional risks that may be present at institutions where there have been demonstrated compliance problems in administering the title IV, HEA programs. For that reason, the larger surety that allows an institution to be considered financially responsible may be as low as 50 percent, the minimum required under the law which states that such a surety must be not less than one-half of its annual potential liabilities. In the alternative, the Secretary may certify the institution provisionally and require the institution to post a letter of credit as low as 10 percent of its prior year's funding.

Where compliance issues are identified with an institution that does not demonstrate financial responsibility under these regulations, or where greater risks are identified in the institution's deteriorated financial condition, the corresponding amounts of surety required to either demonstrate financial responsibility or participate under provisional certification will be higher. Although this larger surety may impose additional hardships on an institution that is experiencing financial difficulties, the corresponding higher risks arising from that institution's continued participation in the title IV, HEA programs warrant the additional protection to the Federal interests.

With respect to the comments that the Secretary should provide an alternative under which an institution would be allowed to post a small letter of credit to demonstrate that it is financially responsible, the Secretary notes that this alternative is not permitted under the law. Under section 498(c)(3)(A) of the HEA, an institution that does not satisfy the general standards of financial responsibility must post a letter of credit of not less than one-half of its potential annual liabilities to demonstrate that it is financially responsible. For this reason, the Secretary structured the

zone alternative to allow a financially weak institution with no compliance problems to continue to participate as a financially responsible institution for up to three consecutive years. This alternative provides institutions scoring in the zone a reasonable period of time to improve their financial condition by working with their accrediting bodies through the formal recovery plans mentioned by the commenter, or by other means. To the extent that an institution is unable to raise its composite score to 1.5 or higher after three years, or if the institution's composite score decreases below 1.0, that institution will generally be able to continue to participate in the title IV, HEA programs by posting a large surety or under a provisional certification with a smaller surety.

Changes: None.

Comments regarding other alternatives: One commenter from a non-profit institution believed that the calculation of a few ratios cannot begin to compare as a true measure of financial strength to a credit rating received by an institution from a major rating agency. Therefore, instead of the proposed methodology the commenter suggested that the Secretary consider any institution whose debt is rated as investment grade (BBB/Baa) or better to be financially responsible.

Many commenters from proprietary institutions argued that in accordance with the language contained in section 498(c)(3)(A) of the HEA, the Secretary should allow institutions to post performance bonds as well as letters of credit as an alternative to meeting ratio standards of financial responsibility.

A commenter from a higher education organization representing public and non-profit institutions suggested the following alternatives for any degree-granting, regionally accredited institution that is designated as a public institution by the State in which it is located or that has been in continuous existence for 25 years or since the authorization of the HEA in November 1965: (1) The institution can meet reasonable tests of self-insurance covering the potential liability of one-half of its annual funding under the title IV, HEA programs, (2) the institution participates in an insurance pool approved by the Secretary that indemnifies the institution for one-half of its annual funding under the title IV, HEA programs, (3) the institution presents a letter of credit covering at least one-half of its annual funding under the title IV, HEA programs, or (4) the institution presents other financial instruments, satisfactory to the Secretary, to cover one-half of the

institution's funding under the title IV, HEA programs.

Similarly, another commenter from a non-profit institution suggested the Secretary (1) should consider that an institution is financially responsible if the institution has been continuously operating with the same management structure for the past 20 years, (2) apply financial responsibility standards only if an institution has exceeded the maximum allowable default rate; and (3) should consider an institution a financial risk and place that institution on some type of probation if the institution has experienced five or more consecutive years of operating deficits, declining net assets, declining net worth, or declining enrollments.

A commenter from a higher education association representing proprietary institutions believed that the 50 percent letter of credit alternative was onerous and excessive and suggested that the Secretary consider the following alternatives: (1) A letter of credit equal to 25 percent of the amount of title IV, HEA program funds received by an institution during the previous year, (2) a performance bond, (3) a 10 percent letter of credit if the institution participates in a State tuition recovery program, (4) instead of reimbursement, the use of an escrow account under which an institution would be allowed to draw title IV, HEA program funds when it earned those funds, (5) a financial guarantee, or infusion of additional capital, by a parent corporation on behalf of an institution, or (6) a 10 percent letter of credit combined with provisional certification but not the reimbursement payment method.

Discussion: Some of the suggested alternatives, such as those relating to longevity, trend analysis, and smaller letters of credit, are not included in these regulations based on the discussion under Analysis of Comments and Changes, Part 9. Regarding the suggestion that the Secretary permit institutions to post performance bonds rather than letters of credit, it has been the Secretary's experience that performance bonds are virtually uncollectible and thus provide little or no protection to the Federal interest.

With respect to the commenters' suggestion that institutions should be able to use self-insurance or insurance pooling as a method of providing surety, the Secretary notes that a letter of credit may be obtained on behalf of an institution from a bank by a number of different entities, and that these regulations do not prevent several institutions (or other entities) from entering into an arrangement with a

bank under which their pooled resources would be used to obtain a letter of credit for an institution that is required to post surety. In the absence of any specific information from the commenters regarding self-insurance or insurance pooling, the Secretary does not modify the regulations to permit any type of insurance pooling that would provide anything other than a letter of credit as surety for an institution.

In response to the comment regarding bond ratings, the Secretary believes that it is unlikely that an institution with an investment grade bond rating will not achieve a composite score of at least 1.5 because, as noted under Analysis of Comments and Changes, Part 6, the financial standards used by rating agencies are more stringent than the standards under these regulations.

While the regulations permit an institution to use its participation in an approved State tuition recovery plan as a substitute for a surety that would otherwise be required if the institution failed to make its refunds in a timely manner, the Secretary does not believe that these plans are appropriate resources to consider for paying liabilities that arise from an institution's administration of the title IV, HEA programs.

The Secretary notes that the cash monitoring payment method may also be used instead of reimbursement for institutions that participate under a provisional certification. This new payment method will reduce the relative burden noted by the commenters who suggested that the reimbursement requirement should be eliminated from the provisional certification procedures.

Changes: The provisional certification alternatives proposed under § 668.178 (b) through (d) are relocated under § 668.175 (f) and (g) and revised to provide that the Secretary may require an institution under either of these alternatives to disburse and request title IV, HEA program funds under the cash monitoring payment method.

Comments regarding alternatives for new institutions: Some commenters objected to the proposal contained in § 668.174(b)(2) under which the Secretary has the discretion to establish the amount of a letter of credit based on the amount of title IV, HEA program funds the Secretary expects that a new institution will receive for the first year it participates under these programs. The commenters believed that the Secretary could use this discretion to establish arbitrarily high letters of credit. As an alternative, the commenters suggested that the Secretary enter into an agreement with an

institution establishing the amount of title IV, HEA program funds the institution may draw down during its initial year of participation. Under this arrangement, the institution would initially submit a letter of credit based on the agreed amount and submit additional letters of credit during the year if the institution needed to draw down title IV, HEA program funds in excess of the agreed amount.

Discussion: While the commenters' suggestion has merit, even if an institution agreed to submit additional letters of credit as a condition under a provisional certification, there is no assurance that the institution would be able to submit those letters of credit. In that circumstance, the institution's continued participation in the title IV, HEA programs would be severely jeopardized, placing at risk both students who relied on Federal funds to attend the institution and the Secretary for providing those funds.

To the extent that the Secretary accepts the risk to the Federal interest by allowing a financially weak institution to participate for the first time in the title IV, HEA programs, that risk must be mitigated at the onset by a letter of credit for an amount that the Secretary estimates is sufficient to cover the institution's potential liabilities. This is not to say that the Secretary will determine the amount of that letter of credit without conferring with the institution.

Changes: None.

Part 10. Comments Regarding Past Performance

Comments regarding substantial control: A commenter representing proprietary institutions was concerned that the past performance standards under proposed § 668.167(a)(1) could adversely affect innocent people. The commenter described a situation where an individual acting as a court-appointed officer of an institution undergoing reorganization under Chapter 11 could be harmed if the institution has title IV, HEA program liabilities and that individual is unable to bring the institution out of Chapter 11 status. The commenter believed that under the current rules, the Secretary would consider that the individual exercised substantial control over this failed institution and thus, because of the unpaid program liabilities could not subsequently exercise substantial control over another institution, i.e., because of the individual's past performance, another institution would not risk losing its ability to participate in the title IV, HEA programs by allowing the individual to exercise

substantial control. The commenter suggested that the Secretary modify the regulations to exclude from these provisions a person who was not employed by an institution at the time that the institution incurred title IV, HEA, program liabilities but who is retained either for the purpose of assisting in a reorganization plan or by a bankrupt corporation under a court-approved process.

Discussion: The commenter correctly notes that the regulations cause an institution to fail the financial responsibility standards if a person that exercises substantial control over the institution either held an ownership interest in another institution that owes a liability or exercised substantial control over that other institution. The regulations also provide that such a failure can be cured either by showing that the liability from the other institution is being repaid under an agreement with the Secretary, or that the person has repaid a portion of that liability that is equivalent to the former ownership interest. If the person did not hold an ownership interest in the other institution, but was instead a board member or executive officer of that institution or related entity, that person's repayment liability is capped at 25 percent of the applicable liability. Furthermore, the regulations provide that the institution whose financial responsibility is being determined may show that the person identified as exercising substantial control over the institution should nevertheless be considered to lack that control, or the institution may show that the person lacked that control over the institution that owes the liability.

The analysis made under this provision will take into consideration whether the liability arose when the person was exercising control over the institution, and whether that person should have ensured that the institution paid the liability. In the commenter's example, it could be reasonable to conclude that a court-appointed bankruptcy trustee with no prior dealings with the institution, who took control when no funds remained available to pay the liability, would not now cause another institution to fail the financial responsibility requirements. In other situations where someone has taken control over an institution that continued to participate in the title IV, HEA programs, it may be appropriate to hold that person accountable under the regulations if prior liabilities remained unpaid.

Changes: None.

Comments regarding administrative actions, program review and audit

findings: One commenter representing proprietary institutions questioned the provision in proposed § 668.177(a)(2) under which an institution would not be considered financially responsible if it had been limited, suspended, or terminated (LS&T) by the Secretary or by a guaranty agency. The commenter maintained that limitations by guaranty agencies could have nothing to do with the financial condition of the institution (for example, the practice of an agency to limit the level of its guarantees to a certain amount per year). Therefore, the commenter believed that these limitations, or any other action taken by guaranty agencies, fall beyond the scope of this provision. The commenter suggested that if a guaranty agency questions the financial condition of an institution, the agency should refer that institution to the Secretary before any action is taken.

Other commenters representing proprietary institutions opined that the proposed provisions under § 668.177(a)(3) are arbitrary. Under these provisions, the Secretary would consider that an institution is not financially responsible based on a material finding in an audit or program review in one of the previous five years. The commenters argued that such a finding might have nothing to do with the financial responsibility of an institution.

Several commenters noted that since the Secretary does not conduct program reviews of all institutions on a regular basis, the limitation on financial responsibility tied to the findings of the institution's two most recent program reviews should be changed to reflect a fixed period of time.

One commenter noted that erroneous program review findings that are settled in favor of an institution are sometimes not settled in a timely fashion. The commenter suggested that the Secretary delay making a determination that an institution is not financially responsible under the past performance standards until after the appeal process is completed.

Discussion: The Secretary reminds the commenters that in addition to satisfying the numeric standard regarding its financial condition (i.e., the composite score standard), to be financially responsible under the provisions in the HEA, an institution must demonstrate that it administers properly the title IV, HEA programs in which it participates and that it meets all of its financial obligations, including repayments to the Secretary for debts and liabilities arising from its participation in those programs. An institution that is the subject of an

adverse action taken by the Secretary or a guaranty agency, or that had a material finding of a program violation in an audit or program review, has clearly mismanaged title IV, HEA program funds and is therefore not financially responsible under these provisions.

The Secretary agrees with the commenters who noted that the proposed past performance provision under which an institution is not financially responsible if that institution had a material finding in either of its two most recent program reviews should be changed because those reviews are not conducted of all institutions on a routine basis.

Changes: The past performance provision regarding program reviews under proposed § 668.177(a)(3)(ii) is relocated under § 668.174(a)(2) and revised to parallel the two-year compliance audit requirement.

Part 11. Comments Regarding Administrative Actions and Other Requirements

Comments regarding the procedures under which the Secretary initiates an LS&T action: A commenter representing proprietary institutions argued that the provision under proposed § 668.177(a)(3)(iii) is arbitrary and highly punitive, because the Secretary would determine that an institution is not financially responsible if the institution submits its financial statements a day late or the Secretary rejects the institution's financial statements. The commenter maintained that this provision is unnecessary since the Secretary already has recourse under § 668.178(a) to initiate an action to limit, suspend, or terminate an institution.

Several commenters from private non-profit institutions asserted that the Secretary should not take an action to limit, suspend, or terminate an institution unless (1) the institution fails to correct or cure deficiencies cited in an audit report within ninety days after receiving formal notification of those deficiencies from the Secretary, or (2) the institution fails to submit an audit report within 30 days after receiving formal notification that the Secretary has not received that audit report.

Discussion: Under the regulations, an institution is required to submit audits within a fixed time period, and an institution's failure to do so is a serious matter. The Secretary expects that institutions will work diligently to ensure that the combined financial statement and compliance audit is submitted on time. To the extent that the commenters suggest that an institution may inadvertently fail to submit an audit on time, that mistake is

routinely corrected when the institution is contacted by the Department and asked to provide the missing audit immediately.

The question of whether it may be appropriate to initiate an administrative action against an institution based upon deficiencies or program violations that are identified in an institution's audit is best resolved on a case-by-case basis. Furthermore, an institution should not wait for the Secretary to notify it of program violations identified in its own audit report before the institution takes steps to correct those violations.

Changes: None.

Comments regarding teach-out plans:

Many commenters from proprietary institutions opposed any additional requirements relating to institutions on provisional certification, on the grounds that current requirements already provide the Secretary with sufficient oversight authority. The commenters specifically opposed the suggested provision that would require teach-out plans from institutions on provisional certification, arguing that earlier teach-out proposals failed because of serious implementation problems.

Discussion: The Secretary is still considering whether it is feasible to require institutions to routinely provide teach-out plans when a review of the financial statements shows that the institution does not demonstrate financial responsibility. Although the Secretary may ask for this information on a case-by-case basis where some heightened risk of closure is indicated, no broader requirement will be included in the regulations at this time.

Changes: None.

Part 12. Comments Regarding the Proposed Transition Period

Comments: Many commenters supported the concept of a transition period under proposed § 668.171 during which the Secretary would consider an institution to be financially responsible if it failed the proposed ratio standards but passed the current standards. However, the commenters suggested that the proposed one-year transition rule be extended to a two-year or three-year period. Some of these commenters agreed that a one-year transition period was necessary to ensure that the standards are not applied retroactively, but suggested that an additional year would be required to allow the Secretary to test and assess the impact of the standards. Other commenters stated that a longer transition period was necessary so that institutions could structure their operations to meet the standards. Several commenters recommended that the Secretary allow

institutions to use either the current or proposed standards for an indefinite period of time.

Many commenters from the proprietary sector recommended that the Secretary allow institutions to use the exceptions to the general standards now contained under § 668.15(d) during the transition period.

Several commenters from the proprietary sector asked the Secretary to clarify how the transition period would work for institutions that have fiscal years ending December 31.

Discussion: The Secretary has considered the suggestions from the commenters to extend the transition period, but continues to believe that the proposed one-year window during which an institution may use either the current standards or the new standards is reasonable. Moreover, a number of changes have been made to the proposed regulations that will minimize any difficulties that an institution may encounter in adjusting to the new measures. For example, an institution whose composite score is less than 1.5 may continue to participate as a financially responsible institution for up to three consecutive years under the zone alternative so long as its composite score is greater than 1.0. Furthermore, by extending the comment period and delaying the issuance of final regulations until 1997, the final regulations will not go into effect until July 1, 1998. This delay in publication while additional comments were sought has also provided institutions with additional time to evaluate their operations under the ratio analysis framework that has been proposed and discussed with the community.

The Secretary agrees to allow an institution that does not satisfy the composite score standard for the transition year to demonstrate that it is financially responsible by satisfying the standards or alternative requirements under § 668.15 or by qualifying under an alternative standard in § 668.175 of these regulations. The Secretary clarifies that such an institution may use the transition-year alternative only once and only for its fiscal year beginning between July 1, 1997 and June 30, 1998. For any fiscal year beginning on or after the effective date of these regulations, July 1, 1998, an institution must satisfy the requirements under these regulations.

In the commenter's example, the transition-year alternative is available to an institution for its fiscal year beginning on January 1, 1998 and ending on December 31, 1998.

Changes: The transition-year provisions proposed under § 668.171(c)

are relocated under § 668.175(e) and revised to provide that an institution may demonstrate that it is financially responsible by satisfying the requirements under §§ 668.15(b)(7), (b)(8), (d)(2)(ii), or (d)(3), as applicable.

Part 13. Comments Regarding Debt Payments

Comments: One commenter representing proprietary institutions questioned the need for the general standard regarding debt payments contained in the proposed § 668.172(a)(3), particularly in view of the proposed ratio methodology. The commenter maintained that there might be reasons why an institution would be late in paying debts or be in violation of a loan agreement, including disputes over the nature and amount of the debt. The commenter believed that in those cases, the violation or delinquency does not indicate financial instability. Another commenter recommended that the general standards contain a provision that allows for the resolution of disputes between an institution and a creditor who has filed suit on a debt that is 120 days past due. Along the same lines, another commenter noted that since there are no alternatives for an institution that is not current in its debt payments, the Secretary should not initiate an action to terminate such an institution without providing the institution an opportunity to rectify this situation.

Discussion: As a condition of demonstrating financial responsibility, an institution is expected to conduct its business affairs in a manner that enables the institution to pay its debts in a timely manner. When any creditor files suit against an institution to collect a debt that is more than 120 days late, the Secretary believes that there is a significantly increased risk that Federal funds could be used improperly, or that Federal funds held in the institution's bank account could be sought by a creditor through the legal system. Furthermore, since such a lawsuit between an institution and a creditor is unlikely to present Federal questions where the Department would be likely to intervene in the legal proceedings, it is reasonable to require the institution to be provisionally certified and post a small letter of credit. The Secretary believes that this additional protection to the taxpayers is warranted where an unpaid, or even disputed, debt has prompted a creditor to initiate a legal proceeding to obtain a judgment against the institution. When an institution fails to demonstrate financial responsibility under the regulations due to the filing of such a lawsuit, the institution would

be given an opportunity to be certified provisionally and post a surety unless other problems were identified that involved the institution's administration of the federal student aid programs.

Changes: None.

Part 14. Comments Regarding the Definition of Terms

Comments: Several commenters requested that the Secretary provide detailed definitions for the following terms used for the financial ratios under proposed § 668.173: intangibles, total expenses, income before taxes, total revenues (particularly if refunds, returns, and allowances are deducted), and long-term debt and total long-term debt (especially as to whether the last two terms include or exclude the current portion of the debt, and whether the terms include long-term debt owed stockholders or other related parties or entities). One of these commenters believed that the term "income before taxes" should be defined as "income from continuing operations before extraordinary items and changes in accounting principles."

One commenter asked whether total revenues include those items included under gross revenues or net revenues as those terms are used on financial statements. This commenter also asked how the definition of total expenses related to the captions "operating expenses" and "other expenses and income" on financial statements, and whether drop and withdrawal accounts, interest, and other non-operating expenses should be included in the definition of total expenses.

Another commenter asked for clarification of the term "unrestricted income." This commenter asserted that under Statement of Financial Accounting Standards 117, unrestricted income can be defined either as total unrestricted income (tuition, fees, contributions, auxiliary revenues, etc.) before considering net assets released from restrictions, or it can be defined as unrestricted income plus any net assets released from restrictions.

Discussion: To assist in clarifying the final regulations, the Secretary provides definitions for the following terms:

Total Expenses—Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations. Losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the

entity except those that result from expense or distributions to owners. Total expenses in the context of this final rule include both operating and non-operating expenses and losses, except extraordinary losses meeting the criteria of APB Opinion No. 30, paragraph 19. Therefore, total expenses for proprietary institutions includes items such as costs of sales, selling and administrative expenses (including interest and depreciation) and other non-operating losses. Total expenses for private non-profit institutions includes similar items of expense and is defined as the required line item in the Statement of Activities entitled Total Expenses for those institutions reporting under the new accounting standards FASB Statement 117.

Total Revenues—Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners. Total revenues in the context of this final rule includes both revenues and gains, except extraordinary gains meeting the criteria of APB Opinion No. 30, paragraph 19. Therefore, total revenues for proprietary institutions includes items such as tuition and fees, bookstore revenues, investment gains, other income and miscellaneous revenue. Revenues are reported net of refunds, returns, allowances and discounts (including tuition discounts) and drop and withdrawals. Total revenues for private non-profit colleges and universities includes similar items of revenue and is defined as the required line item in the Statement of Activities typically entitled Total Unrestricted Income for those institutions reporting under the new accounting standards FASB Statement 117. Unrestricted income includes unrestricted revenues, gains and other support including net assets released from restrictions during the period.

The Secretary wishes to clarify that the definition of total revenues includes net assets released from restrictions of private non-profit colleges and universities. In accordance with the AICPA Audit and Accounting Guide for Not-for-Profit Organizations as of June 1, 1996, certain items such as investment gains may be reported net of fees with

appropriate disclosure in the footnotes to the financial statements.

Income Before Taxes—Income before taxes is defined as income from operations before extraordinary items, discontinued operations, and changes in accounting principles. The Secretary wishes to clarify that the definition of income before taxes does not include income or loss from discontinued operations. However, the Secretary may consider the effect of extraordinary items, discontinued operations, and changes in accounting principle in the overall evaluation of financial responsibility.

Changes: None.

Part 15. Comments Regarding the Proposed Standards and Requirements for Institutions Undergoing a Change in Ownership

Comments regarding the proposed letter of credit and personal financial guarantee provisions: Several commenters believed that the Secretary took an extreme position that will prevent owners from selling their institutions by proposing under § 668.175 that a new owner either (1) submit a letter of credit equal to 50 percent of the title IV, HEA program funds that the Secretary estimates the institution will receive during its first year under new ownership, or (2) provide personal financial guarantees.

Some commenters opposed the requirement of financial guarantees for several reasons. First, the commenters maintained that since recent changes of ownership have resulted in financially stronger rather than financially weaker institutions, the guarantees are not necessary. Second, they believed that the guarantees would slow the process of obtaining approval from the Secretary for a change of ownership. Third, the commenters argued that the provision for personal financial guarantees is not common in the business world and would negate the concept of a corporation. Moreover, the commenters opined that personal financial liability should only be required in cases involving personal wrongdoing; in other cases, it only serves to discourage strong owners from buying financially troubled institutions.

Many other commenters from proprietary institutions stated that they would support the proposed rules for institutions that change ownership only if: (1) The new rules speed up the process under which the Secretary determines whether to allow those institutions to participate in the title IV, HEA programs, or (2) provide uninterrupted participation for institutions that change ownership.

However, the commenters did not believe the proposed rules would achieve either of these objectives.

Comments regarding the consolidating date of the acquisition balance sheet: Several commenters maintained that requiring a consolidating date of the acquisition balance sheet would be unnecessary, expensive, and time consuming. Some of these commenters asserted that such a requirement would limit the marketability of institutions, or destroy the value of small institutions, because it would require an institution to close its books as of the acquisition date and have a complete audit performed, resulting in large audit costs and losses of time. According to one of the commenters, these costs could be avoided for a publicly traded corporation if the Secretary would agree to determine financial responsibility from the information contained in the financial statements included as part of the corporation's quarterly reports to the SEC. The commenter noted that these financial statements would be no more than 90 days old, and believed that the Secretary could rely on their accuracy for two reasons: the SEC levies criminal penalties against corporations that file inaccurate statements, and the statements are reviewed by an independent CPA.

Another commenter requested the Secretary to clarify how the current requirement under which an institution provides an audited balance sheet when it applies for a change of ownership differs from the proposed requirement that the institution submit a consolidating date of acquisition balance sheet.

Comments containing alternative proposals for institutions undergoing a change in ownership: Several commenters suggested that an institution undergoing a change of ownership that meets the general requirements should be exempt from the letter of credit or personal financial guarantees requirements if the institution achieves the required ratio score based on a balance sheet audit or an audited financial statement that covers only part of a year. The commenters preferred this approach over the proposed requirements under which the Secretary would maintain the letter of credit or keep in place the personal financial guarantees until the institution completed a full fiscal year.

One commenter offered several ways to deal with changes of ownership. First, the commenter suggested that the Secretary charge a reasonable fee for processing change of ownership applications, believing that it is fair to

compensate the Secretary for committing trained staff to process application requests timely. Moreover, the commenter opined that this suggestion would eliminate frivolous and unqualified requests. Second, the commenter believed that the Secretary should examine applications from existing owners purchasing existing institutions differently from new owners with no experience in the school business entering the business. In either case, the commenter argued that the Secretary should approve a change of ownership request without interrupting the acquired institution's title IV, HEA program funds if the owner satisfies certain conditions. For an existing owner, the owner must demonstrate that he or she has managed an institution participating in the title IV, HEA programs to the highest standards. According to the commenter, the owner's current institution must have: (1) A low cohort default rate (20 percent or lower), (2) an excellent job placement rate (80 percent or more), (3) less than 1 percent audit exceptions, (4) been in business for five years or more, and (5) resolved any actions taken by the Secretary, an accrediting agency, or the State.

For a new owner purchasing an existing institution, the commenter suggested that the Secretary (1) require that owner to submit a letter of credit (or cash) for an amount equal to three months of the amount of title IV, HEA program funds that the institution received in the prior year, and (2) limit any increase in the amount of title IV, HEA program funds the institution receives during its first 12 months under new ownership to 10 percent over the amount the institution received in the prior year.

Another commenter suggested lowering the percentage of the letter of credit, asserting that no business acquiring an institution could possibly post a letter of credit for 50 percent of the title IV, HEA program funds that the institution would receive.

Finally, a commenter from a proprietary institution suggested that the Secretary could establish standards for the Equity and Primary Reserve ratios for institutions that change ownership that are higher than the standards established for participating institutions.

Comments regarding other change of ownership issues: A commenter requested that the Secretary clarify whether the proposed requirements for an institution undergoing a change would eliminate the current provision under which that institution is provisionally certified.

Another commenter inquired whether the excluded transactions described under § 600.31(e) would continue to exempt an institution from the change of ownership provisions under proposed § 668.175.

One commenter argued that it was erroneous to assume that a change of ownership results in a change of control. The commenter believed that a change of ownership occurs when a corporation releases a majority of its stock on the market. However, the commenter reasoned that a change of control does not occur if a large number of shareholders acquire that stock since no shareholder acquires a controlling interest. Moreover, the commenter concluded the Secretary should not require a financial statement audit or surety if the corporation was financially responsible before such an event because the financial condition of the corporation does not change as a result of this event. Therefore, the commenter suggested that the Secretary amend proposed § 668.175(a) so that it applies only to a change of ownership that results in a new person or entity exercising substantial control over the institution, or if the institution's financial statement is affected by the change.

Comments regarding additional locations: Several commenters opposed the proposal under which the Secretary could require personal financial guarantees or letters of credit for additional locations of an institution, arguing that it is inappropriate to require such letters or guarantees in any situation other than one involving past misconduct. Moreover, the commenters believed that the Secretary should not consider the expansion of operations as an event that requires heightened scrutiny.

Another commenter added that it was inappropriate to single out additional locations for heightened scrutiny since other forms of expansion, including the rental of additional buildings or the expansion of housing or research facilities, could have an equal impact on an institution's financial situation. In any event, the commenter suggested that the guarantees should only remain in place until the institution demonstrates that it is financially responsible and that such guarantees should not exceed 50 percent of the amount of title IV, HEA program funds that would be received by the additional location.

One commenter asked that the Secretary clarify the types of financial surety that would be required for an additional location. The commenter stated that if the surety was limited to personal financial guarantees, a publicly

traded corporation could not add locations, because shareholders who are purely investors would also be required, but would refuse, to provide personal guarantees. Therefore, the commenter recommended that the Secretary accept instead irrevocable letters of credit.

Another commenter suggested that decisions regarding additional locations should be made by accrediting agencies in accordance with the regulations contained in § 602.27. Under this suggestion, if the accrediting agency determines that an institution is administratively capable and financially responsible, then the institution would be allowed to open the additional location without any other restrictions. If the accrediting agency determines otherwise, then the institution would not be allowed to open that location even if the institution is willing to provide a surety.

A commenter asserted that it was important to describe the conditions under which the Secretary would draw upon a surety provided when an institution adds an additional location, because these conditions will profoundly affect the cost of the surety. In particular, the commenter asked whether the Secretary would draw upon the surety only if an institution closed, or under other circumstances, and whether the amount drawn would be the amount equal to unpaid refunds and improperly disbursed title IV, HEA program funds, or some other amount.

Discussion: The Secretary thanks the commenters for their suggestions and recommendations under this Part, but notes that several issues raised by the commenters relating to institutional participation, application and certification procedures, and additional locations fall beyond the scope of the proposed financial responsibility regulations. Consequently, the Secretary could not amend the applicable sections of the regulations that address those areas and procedures. Moreover, because changes to those areas and procedures will likely affect how the Secretary determines whether institutions undergoing a change of ownership are financially responsible, and to harmonize any new financial standards with those changes, the Secretary will delay promulgating final financial responsibility regulations for those institutions. In the meantime, the financial responsibility of an institution that undergoes a change of ownership will be determined under current regulations and administrative procedures.

Changes: The Secretary withdraws the provisions under proposed § 668.175 that an institution undergoing a change

in ownership would be financially responsible only if the persons or entities acquiring an ownership interest in that institution provide personal financial guarantees or letters of credit. The Secretary will in the future propose regulations regarding changes of ownership and other related issues.

Final Regulatory Flexibility Analysis

The Secretary has determined that a substantial number of small entities are likely to experience significant economic impacts from this regulation. Thus, the Regulatory Flexibility Act (RFA) required that an Initial Regulatory Flexibility Analysis (IRFA) of the economic impact on small entities be performed and that the analysis, or a summary thereof, be published in the Notice of Proposed Rulemaking. The IRFA was performed and a summary was published in the Notice of Proposed Rulemaking for this rule. This Final Regulatory Flexibility Analysis (FRFA) discusses the comments received on the IRFA and fulfills the other RFA requirements.

The Department of Education has a long history of providing compliance assistance to institutions participating in the Title IV, HEA programs, in the form of guidance, training, and access to staff for individualized assistance. The Department will provide similar support to institutions in implementing this new rule. This assistance fulfills the letter and the spirit of the RFA requirement that this assistance is provided to small entities.

Summary of Significant Issues Raised by the Public Comments on the IRFA, a Summary of the Assessment of the Department of Such Issues, and a Statement of Any Changes Made in the Proposed Rule as a Result of Such Comments

In the notice of proposed rulemaking, the Secretary invited comments on the IRFA, particularly comments on the definition of small entities, the estimation of the number of institutions likely to experience economic impacts, and the estimated costs of alternative demonstrations of financial responsibility. No comments were received on these issues, but other comments on the RFA and small entities were received. These comments are discussed here.

Comments: Many commenters from the proprietary sector maintained that the Secretary had not met the burden of proof required in the RFA regarding the Department's reasons for taking action.

Discussion: The RFA requires the Secretary to publish a description of the reasons why action by the Department

was taken and a succinct statement of the objectives of, and legal basis for, the final rule. In the next section of this FRFA and in the preamble, the Secretary describes why the Department took action. The Secretary believes this explanation satisfies the RFA requirements.

Changes: None.

Comments: A commenter representing proprietary institutions questioned the manner in which the first KPMG study was conducted. The commenter believed that small business interests were not considered since no representatives of small proprietary institutions were among those institutional representatives that assisted with the first KPMG study. Moreover, the commenter asserted that this omission, as well as the fact that the Secretary did not consider the comments submitted by a group of CPAs on behalf of proprietary institutions regarding the first KPMG report, violated the requirement in the RFA that the Secretary confer with representatives of small businesses.

Discussion: The Secretary has conferred extensively with representatives of all types of postsecondary institutions throughout the period of this rulemaking process. This consultation goes well beyond the RFA requirement that the Secretary confer with representatives before the final rule is published. This consultation is evidenced by the fact that the group of CPAs to whom this commenter referred had received the first KPMG report when that report was in its draft stage, and had time to consider and provide extensive comments on that draft report. The Secretary distributed a draft of that report to all sectors, including representatives of small proprietary institutions. The comments received were considered carefully by the Department and KPMG before the August 1996 KPMG report was issued, and considered again before the NPRM was published. During the comment period on this rule, the Secretary had extensive discussions with the postsecondary community, as discussed in the preamble. These discussions included several representatives of small for-profit and small non-profit institutions.

Changes: None.

Comments: Many commenters from proprietary institutions concluded from the discussion in the IRFA section of the NPRM that the ratio standards are weighted heavily against the for-profit sector.

Discussion: The Secretary feels that the ratio standards are correctly tailored

to measure financial health at different institutions. The final rule has been designed so that institutions across all sectors that demonstrate similar levels of financial health receive similar scores. Thus, a proprietary institution that earns a score of 2.0 will have approximately the same level of financial health as a non-profit institution with the same score. As discussed in the IRFA, the estimates of the number of institutions experiencing economic impacts used in that analysis were based on the best information available at that time. That information came from a judgmental sample of financial statements in which financially weak institutions were intentionally over-sampled in order to provide as clear a picture as possible of these institutions. The estimates contained in this FRFA were obtained from a non-judgmental sample of institutions and thus represent improved estimates of the number of institutions likely to experience economic impacts. It is true that institutions in the proprietary sector are more likely to experience negative economic impacts from this rule. The degree to which a higher proportion of proprietary institutions do not attain passing scores is consistent with the lower levels of financial health in that sector evidenced by the audited financial statements analyzed by the Department and KPMG.

Changes: The FRFA contains improved estimates of the number of institutions likely to experience economic impacts. These estimates are based on a larger and non-judgmental sample.

Comments: Several commenters from proprietary institutions asserted that the proposed standards favor large or publicly traded corporations at the expense of small and new institutions. Other commenters believed that many small institutions with good educational and compliance records that pass the current standards would fail the proposed standards. The commenters opined that this outcome points to a flaw in the manner in which the methodology treats small institutions. An accountant for a proprietary institution argued that because the proposed methodology does not provide an adjustment for size, it is unfair to compare an institution with \$10 million in tuition revenue to an institution with \$500,000 in tuition revenue by applying the same standards and criteria to both institutions.

Discussion: As discussed elsewhere in the preamble, the final methodology does account for the size of the institution by using ratios that consider

an institution's financial strength in relation to certain characteristics of the institution. It is estimated that between 105 and 165 small institutions that pass the current standards would fail the new standards. The Secretary believes that, based on this more comprehensive and accurate measure, these institutions have a sufficiently poor financial condition to warrant additional oversight of the Federal funds administered by these institutions, irrespective of their educational and compliance records.

Changes: None.

Comments: A commenter representing private non-profit institutions asserted that the letter of credit alternative was not feasible for small, frugal institutions that are tuition-driven. The commenter suggested that these institutions should not be required to provide letters of credit, or that only those institutions that have audit or program review liabilities be required to provide a letter of credit. Several commenters from the proprietary sector stated that a small institution may not be able to afford the cost of obtaining a large letter of credit, or have available sufficiently large credit lines to secure a 50 percent letter of credit. The commenters stated that a more equitable alternative would be for the Secretary to expand the alternative methods of demonstrating financial responsibility for small entities to include a provision under which those entities could provide a letter of credit in the amount of five percent or 10 percent of their prior-year title IV, HEA program funds. The commenters also recommended that for all institutions, an alternative should be the provision of a letter of credit in an amount ranging from five percent to 50 percent of the institution's prior-year title IV funds, tied to the perceived shortfall in funds, or to the operating loss that triggered the institution's failure to meet the standards.

Discussion: The Secretary understands that small (and large) institutions that are in poor financial condition may have difficulty obtaining a 50 percent letter of credit. This requirement is only imposed on institutions whose ability to continue operations is highly uncertain. Furthermore, there are other alternatives by which institutions can continue to participate in the title IV, HEA programs without posting a 50 percent letter of credit. For instance, institutions can participate under provisional certification by posting a 10 percent letter of credit. Other alternative methods were considered and rejected, including the alternatives described by

the commenters. These alternatives are discussed earlier.

Changes: This final rule contains the zone alternative, under which financially weak institutions may continue to participate without posting a letter of credit.

Comments: Several commenters representing proprietary institutions believed that personal financial guarantees are unfair and arbitrary, because the guarantees would expose the owners of small family businesses to the loss of personal assets, including their homes and savings.

Discussion: The proposed alternative of providing personal financial guarantees was intended to provide owners with additional options, and was available at the discretion of the owner of the institution. The provision of collateral is standard operating practice in the financial sector and this proposed alternative was offered to provide institutions with flexibility in meeting the financial responsibility standards. The Secretary does not feel that providing an alternative that can be exercised at the option of the small business owner is unfair or arbitrary. However, the resources of the Department can be better utilized in administering the provision associated with the zone alternative than in administering personal financial guarantees.

Changes: The personal financial guarantee alternative has been removed from the final rule.

Description of the Reasons Why Action by the Department Was Taken and a Succinct Statement of the Objectives of, and Legal Basis for, the Final Rule

The Secretary is directed by section 498(b) of the HEA to establish that institutions participating in title IV, HEA programs are financially responsible. The Department, as part of its regulatory reinvention process, has analyzed the current standards for institutions to demonstrate financial responsibility and found that improvements are both possible and needed. The tests of financial responsibility are being modified so that they more accurately reflect the financial health of the institutions participating in the programs. The modifications provide different tests for each postsecondary sector. Institutions are evaluated according to standards appropriate to their sector and financial practices and conditions. More information about the need and justification for this rule can be found elsewhere in the preamble.

Description and Estimate of the Number of Small Entities to Which the Proposed Rule Will Apply

The Secretary has applied the U.S. Small Business Administration (SBA) Size Standards to the set of institutions that will be affected by this rule. Postsecondary educational institutions are classified in the Standard Industry Classification (SIC) in Major Industry 82—Educational Services. Within this SIC, all subclassifications except Flight Training Schools have the same criterion for qualifying as a small business. This criterion is that the business have total annual revenue less than or equal to \$5 million. Thus, for the purposes of analyzing this regulation, for-profit and non-profit businesses with total annual revenue less than or equal to \$5 million are considered small entities. For public institutions, the SBA standard is that the governmental body that is responsible for the institution have a population less than 50,000. For instance, a postsecondary vocational institution that is operated by a county with a population under 50,000 would be considered a small governmental entity using the SBA Size Standard.

In order to determine the number of small institutions to which the rule will apply, an analysis was performed using a census of postsecondary educational institutions. This census is named the Integrated Postsecondary Educational Data System (IPEDS) and is maintained by the U.S. Department of Education's National Center for Education Statistics (NCES). All postsecondary educational institutions that participate in the title IV, HEA programs are required, as a condition of participation, to fully participate in the IPEDS data collections. The last year for which finance data were collected covered the 1993–94 academic year. These data were required to categorize the institutions by their total revenue. The actual data point that is collected is "Total Current Fund Revenue," which is used as a proxy for Total Revenue. The differences between this measure and the measure used by SBA are considered negligible; in any case, this is the only measure available. For small governmental entities, data on the size of the population of the governing body was not available for this analysis. However, a decision was made to err on the side of including more institutions rather than run the risk of including too few in the "small" category. For that reason, any public institution that was controlled at any level below that of a state was considered a small institution

for this part of the analysis. No adjustment was available for growth or shrinkage of the number of participating institutions. However, the analysis shows that a substantial number of small entities will be affected by the proposed rule and no adjustment factor would change that, so the question of adjusting to current program participation levels is not important for the determination of whether a substantial number of small entities would be affected by the proposed regulation.

The estimates are that this rule will apply to 1,690 small for-profit entities, 660 small non-profit entities, and 140 small governmental entities. The RFA directs that these small entities be the sole focus of the Regulatory Flexibility Analysis.

Estimate of the Number of Institutions Experiencing Economic Impacts From the Rule

There are no significant adverse economic impacts of these regulations on public entities. This is because public entities are assumed to satisfy the financial responsibility requirements by virtue of their backing by the full faith and credit of the State or other governmental body where they are located. The minimal reporting requirements contained in this rule for public entities to establish their public status do not represent a significant economic impact. It is estimated that this would represent four hours of time per institution. Using a loaded labor rate of \$20.00 per hour, this would cost each small public institution \$80.00. This is similar to the paperwork burden associated with the current rule with regard to public institutions, so no change in the economic impact on these entities is expected.

The small for-profit and small non-profit entities that would experience adverse economic impacts from this rule are those that would not pass the new financial responsibility test and would be required to provide additional surety to continue participating in the title IV, HEA programs, or to comply with the heightened monitoring required of institutions.

Any institution that does not pass the financial ratio test can post a letter of credit worth at least 50 percent of its previous year's title IV, HEA program funds. Institutions that use this alternative will be considered financially responsible.

Institutions that fail the financial ratio test can post a letter of credit worth at least 10 percent of their previous year's title IV, HEA program funds, comply

with additional reporting requirements, provide early financial audits if requested, and participate under reimbursement or one of the cash monitoring payment methods. Institutions that use this alternative will not be considered financially responsible and will be provisionally certified to participate in the programs.

Institutions that fall into the zone can participate by complying with additional reporting requirements, providing early financial audits if requested, and participating under reimbursement or one of the cash monitoring payment methods. Institutions in the zone that use this alternative will be considered financially responsible. This alternative method of demonstrating financial responsibility for institutions in the zone is available for only three out of any four years. An institution which was in the zone for three years must pass the ratio test at the end of the third year or it will be considered to have failed the financial ratio test and must participate under one of the alternatives described above (50 percent letter of credit, or 10 percent letter of credit with provisional certification and heightened monitoring).

The Department contracted with KPMG to perform an analysis of the financial tests that will be conducted on audits submitted by participating institutions. Using the KPMG sample to infer to the population, the following estimates were obtained. An estimated total of 220–390 small institutions that failed the old financial responsibility test would have passed the new test or been eligible for the zone alternative, had it been in effect during this period. For these institutions, the proposed changes would have had a positive economic impact because they would have been spared the expense of an alternative demonstration of financial responsibility. At the same time, an estimated total of 280–415 small institutions that passed the old financial responsibility test would have failed or fallen into the zone under the new test. For these institutions, these changes would have had a negative impact because they would have had to go to the expense of posting surety or heightened monitoring, or both, as discussed in the next section. A fuller description of these institutions, broken down by the type of organization, is presented in Table 1.

TABLE 1. ESTIMATED NUMBER OF INSTITUTIONS EXPERIENCING ECONOMIC IMPACTS

Status with regard to old and new financial responsibility tests	Small for-profit institution	Medium and large for-profit institution	Small non-profit institution	Medium and large for-profit institution
Old test: Pass. New test: Pass (no economic impact)	1,300-1,400 56%-71%	75-125 29%-83%	300-350 50%-81%	875-950 53%-68%
Old test: Pass. New test: Zone (adverse economic impact)	150-200 6%-10%	15-25 6%-17%	25-50 4%-12%	20-40 1%-3%
Old test: Pass. New test: Fail (adverse economic impact)	100-150 4%-8%	15-25 6%-17%	5-15 1%-3%	10-20 0%-1%
Old test: Fail. New test: Pass (positive economic impact)	75-125 3%-6%	10-20 4%-13%	50-100 8%-23%	400-450 24%-32%
Old test: Fail. New test: Zone (positive economic impact)	75-125 3%-6%	5-15 2%-10%	20-40 3%-9%	50-100 3%-7%
Old test: Fail. New test: Fail (possible positive economic impact)	275-325 12%-16%	30-50 12%-33%	30-50 5%-12%	50-100 3%-7%

Source: Department and KPMG analysis from sample data.

Estimates of Economic Impacts

The economic impact of the new financial tests depends on the alternative method that the institution uses to continue participating in the title IV, HEA programs. It is impossible to determine what alternative these entities will choose. Of course, one alternative that is available to entities is to discontinue participation in the programs. Using the economic principle of profit-maximization (or cost-minimization for non-profit entities), entities that would choose to discontinue participation have demonstrated that their cost of withdrawal is lower than their cost of these alternative methods for demonstrating financial responsibility. Therefore, these costs represent estimates of maximum economic costs associated with the choice of alternative certification or withdrawal from the title IV, HEA programs. It is difficult to determine the cost of withdrawal from participation in these programs.

Post a Letter of Credit Equal to at Least 50 Percent of the Institution's Prior Year Title IV, HEA Program Funds

The cost of posting a letter of credit varies according to the particular financial situation of the institution employing this alternative. The cost also depends on the type of relationship that the institution has with its bank. The costs estimated here assume that the institution has no relationship with a bank that would allow the bank to rely on its institutional knowledge to more accurately determine the risk of having to pay out the letter of credit. Thus, the estimates here are overstated for at least some institutions that have such a relationship with their banks.

For the purposes of this analysis, costs will be estimated for a small institution of typical size. An institution with annual title IV revenue of \$2

million would be required to post a letter of credit of \$1 million. The bankers representing local, regional, and national commercial banks contacted by KPMG stated that they would charge a fee of between 0.75 percent and 1.25 percent for such an institution, or between \$7,500 and \$12,500. In addition, the bankers stated that the institution would be required to collateralize the letter of credit. Using an opportunity cost of the collateral of four points above the prime rate (12.5 percent), this would represent an estimated opportunity cost of \$125,000. The bankers indicated that the fees and requirements would be similar for both proprietary and private non-profit institutions.

It is estimated that about one-fifth of the institutions that fail the financial responsibility test will choose to post a 50 percent letter of credit. This estimate represents the best professional judgment of Department program staff. Institutions that fail the old and new standards and are already participating with this alternative will not experience an economic impact from this provision. This estimate is based on the assumption that none of the institutions in the zone will choose to post a 50 percent letter of credit, since the other alternative for institutions in the zone has a lower economic impact. The letter of credit alternative is available for institutions in the zone under the statute. Some institutions may experience different economic costs than those estimated here and find the 50 percent letter of credit alternative more attractive than the other requirements in the zone alternative.

Post a Letter of Credit Equal to at Least 10 percent of the Institution's Prior Year Title IV Funds and Participate Under Provisional Certification

As discussed above, the costs of securing a letter of credit depend on the particular financial situation of the institution and the type of relationship that the institution has with its bank.

For the purposes of this analysis, costs will be estimated for a small institution of typical size. An institution with annual Title IV revenue of \$2 million would be required to post a letter of credit of \$200,000. The bankers contacted by KPMG stated that they would charge a fee of between 0.75 percent and 1.25 percent for such an institution, or between \$1,500 and \$2,500. In addition, the bankers stated that the institution would be required to collateralize the letter of credit. Using an opportunity cost of the collateral of four points above the prime rate (12.5 percent), this would represent an estimated opportunity cost of \$25,000. The bankers indicated that the fees and requirements would be similar for both proprietary and private non-profit institutions.

It is estimated that about four-fifths of the institutions that fail the financial responsibility test will choose to post a 10 percent letter of credit. This estimate represents the best professional judgment of Department program staff. Institutions that fail the old and new standards, and are already participating with this alternative, will not experience an economic impact from this provision.

Additional Reporting

Institutions that fail the financial responsibility ratio test or use the zone alternative to demonstrate financial responsibility will be required to report significant adverse financial or oversight events to the Department. It is estimated

that about one-fifth of institutions using the zone alternative will have an average of 1.5 events per year that they would have to report to the Department. It is estimated that about one-third of institutions that fail the ratio test will have an average of two events per year that they would have to report to the Department.

Reporting each event is expected to take about 15 minutes. Using a loaded labor rate of \$20.00 per hour, reporting each event will cost the institutions \$5.00. An estimated one-fifth of the institutions using the zone alternative will experience an average economic impact of \$7.50. An estimated one-third of the institutions that fail the ratio test will experience an average economic impact of \$10.00.

These estimates represent the best professional judgment of Department program staff.

Early Submission of Audits

Institutions that fail the financial responsibility ratio test or use the zone alternative to demonstrate financial responsibility may be required to submit early financial audits to the Department, at the Department's discretion. It is expected that these institutions will be required to submit these audits within 60 days of the end of the fiscal year. It is estimated that the Department will exercise that discretion for about one-half of the institutions using the zone alternative, and about two-thirds of the institutions that fail the ratio test.

The only economic impact institutions will experience from being required to submit their audited financial statements early is any higher fees that may be charged to the institutions by their auditors. KPMG researched the types of fees that a national, regional and local accounting firm would typically charge for this service. It was estimated that a small institution with about \$2.5 million in total revenue and one campus would be charged between \$6,000 and \$8,000 in additional fees for a combined financial and compliance audit performed in January or February. The accounting firms also stated that institutions with fiscal years that do not end on December 31 would probably not be subject to additional fees as long as they receive sufficient advance notice of this requirement.

Cash Monitoring, Type 1

Institutions that are required to obtain title IV, HEA program funds through the first type of cash monitoring will be required under § 668.162(e)(1) to credit students' accounts before drawing federal funds. The institution's

compliance audit will contain verification that this did occur throughout the year. There is no additional paperwork associated with this option. There will be some minimal one-time costs associated with changing from the advance payment method to this payment method. It is difficult to estimate what changing payment systems might cost since it would vary depending on the administrative structure of the institution. It is expected that it might take a small institution an estimated 40 hours to reprogram its financial system and make other adjustments. Using a loaded labor rate of \$50.00 per hour for this type of technical work, the estimated economic impact is \$2,000. Since institutions are expected to credit students' accounts and draw federal funds in the same banking day, there should be no borrowing costs associated with this payment method. Under the advance payment system, institutions are allowed to keep up to \$250 in interest earned from depositing federal funds in advance of disbursing it to students. Institutions that are no longer able to participate on advance payment would lose the portion of that \$250 they were able to earn.

It is estimated that about three-fourths of the institutions participating under the zone alternative will be placed on this level of cash monitoring. It is estimated that about five-eighths of institutions who fail the ratio test and participate under the 10 percent letter of credit alternative will be placed on this level of cash monitoring.

Institutions that fail the old and the new test of financial responsibility and participate under provisional certification may experience a positive economic benefit from this provision. Under current rules, institutions can only participate under the current reimbursement system. To the degree that these institutions are allowed to participate using a less stringent type of cash monitoring than that available under current rules, they will experience a positive economic benefit.

Cash Monitoring, Type 2

Institutions that are required to obtain title IV, HEA program funds through the second type of cash monitoring will be required under § 668.162(e)(2) to credit students' accounts and provide some documentation of students and amounts before receiving federal funds. The institution's compliance audit will contain verification that this did occur throughout the year. Institutions will be required to document students and amounts and submit this to the Department. This is expected to

represent about one hour of paperwork for the small institution and cost about \$20.00 using a loaded labor rate of \$20.00 per hour. As discussed above, there will be some one-time costs associated with changing from the advance payment method to this payment method, which are estimated at \$2,000. Institutions are expected to credit students' accounts and receive federal funds within six days. Institutions will be receiving some or even all of the federal funds in the form of student charges, so they are not expected to be required to borrow the entire amount of the delayed funds. However, they will experience the economic impact of not having the opportunity to use these funds for that six-day period. The opportunity cost of capital is estimated here at the borrowing rate. It is assumed that institutions in such a situation could obtain a short-term loan at their bank for an annual interest rate of prime plus four points, or about 12.5 percent. This yields an economic cost of about \$2,000 per million dollars of title IV, HEA program funds received annually. As discussed above, institutions would also lose up to \$250 in interest fees on advance payments they may have been earning.

It is estimated that about one-eighth of the institutions participating under the zone alternative will be placed on this type of cash monitoring. It is estimated that about one-eighth of the institutions who fail the ratio test and participate under the 10 percent letter of credit alternative will be placed on this type of cash monitoring.

Institutions that fail the old and the new tests of financial responsibility and participate under provisional certification may experience a positive economic benefit from this provision. Under current rules, institutions can only participate under the current reimbursement system, under § 668.162(d). To the degree that these institutions are allowed to participate using a less stringent type of cash monitoring than that available under current practice, they will experience a positive economic benefit.

Reimbursement

Institutions that are required to obtain title IV, HEA program funds through the current reimbursement system will be required to credit students' accounts and provide supporting documentation to the Department before receiving federal funds. The institution's compliance audit will contain verification that this did occur throughout the year. Institutions will be required to compile the paperwork and

submit this to the Department. This is expected to represent about five hours of paperwork, that will cost about \$100 using a loaded labor rate of \$20.00 per hour. As discussed above, there will be some one-time costs associated with changing from the advance payment method to this payment method, which are estimated at \$2,000. Institutions are expected to credit students' accounts and be reimbursed with federal funds within 24 banking days. As discussed in more detail above, there is an economic cost of not having the use of those funds for that 24 day period, which is estimated at \$8,000 per million dollars of title IV, HEA funds received annually. As discussed above, institutions would also lose up to \$250 in interest fees on advanced payments they may have been earning.

It is estimated that about one-eighth of the institutions participating under the zone alternative will be placed on reimbursement. It is estimated that about one-fourth of the institutions who fail the ratio test and participate under the 10 percent letter of credit alternative will be placed on reimbursement.

Optional Disclosure in Audited Financial Statement of HEA Institutional Grants

Institutions that would otherwise fail or be required to use the zone alternative that wish to have their HEA institutional grants excluded from the calculation of their ratios would be required to have the amount of the HEA institutional grant disclosed in a note to their financial statements, or in a separate attestation. KPMG researched

the types of fees that a national, regional and local accounting firm would typically charge for this service. It was estimated that a small institution with about \$2.5 million in total revenue and one campus would be charged about \$300 for this information disclosed as a note to the financial statements, and between \$2,000 and \$3,000 if the institution chose to have this disclosed as a separate attestation. It is assumed that institutions will choose the note disclosure due to its lower cost.

It was not possible to estimate the number of institutions that could be able to take advantage of this option, since these data were not available from the audited financial statements analyzed here.

TABLE 2.—SUMMARY OF ESTIMATED ADVERSE ECONOMIC IMPACTS ON SMALL ENTITIES

Action (not all actions are required of all institutions)	Institutions that fail the ratio test	Institutions using the zone alternative
50 percent letter of credit	One-fifth of institutions will pay fees of \$7,500 to \$12,500 per million, plus estimated opportunity cost of \$125,000 per million.	No institutions eligible for the zone alternative are expected to post letters of credit.
10 percent letter of credit	Four-fifths of institutions will pay fees of \$7,500 to \$12,500 per million, plus estimated opportunity cost of \$125,000 per million.	No institutions eligible for the zone alternative are expected to post letters of credit.
Additional reporting	One-third of institutions will have average paperwork costs of about \$10.	One-fifth of institutions will have average paperwork costs of about \$7.50.
Early submission of audits	Two-thirds of institutions will have increased audit costs of between \$6,000 and \$8,000.	One-half of institutions will have increased audit costs of between \$6,000 to \$8,000.
Cash monitoring, type 1	Five-fifths of institutions who fail the ratio test and participate under the 10 percent letter of credit alternative will have: costs of changing payment system of about \$2,000; and loss of interest revenue up to \$250.	Three-fourths of institutions will have: costs of changing payment system of about \$2,000; and loss of interest revenue up to \$250.
Cash monitoring, type 2	One-eighth of institutions who fail the ratio test and participate under the 10 percent letter of credit alternative will have: paperwork costs of \$20; costs of changing payment system of about \$2,000; borrowing costs (or opportunity cost of capital) of about \$2,000 per million dollars of Title IV funds received; and loss of interest revenue up to \$250.	One-eighth of institutions will have: paperwork costs of \$20; costs of changing payment system of about \$2,000; borrowing costs (or opportunity cost of capital) of about \$2,000 per million dollars of Title IV funds received; and loss of interest revenue up to \$250.
Reimbursement	One-fourth of institutions who fail the ratio test and participate under the 10 percent letter of credit alternative will have: paperwork costs of \$100; costs of changing payment system of about \$2,000; borrowing costs (or opportunity cost of capital) of about \$8,000 per million dollars of Title IV funds received.	One-eighth of institutions will have: paperwork costs of \$100; costs of changing payment system of about \$2,000; borrowing costs (or opportunity cost of capital) of about \$8,000 per million dollars of Title IV funds received.
Action	Institutions that initially fail but employ optional disclosure to raise score into zone.	Institutions that initially fall into the zone but employ optional disclosure to raise score to passing.
Optional disclosure of HEA institutional grants	An unknown number of institutions will have an economic impact of \$300.	An unknown number of institutions will have an economic impact of \$300.

NOTE: All of the figures in this table are estimates. The previous discussion provides a complete explanation of how these estimates were made.

Description of Significant Alternatives Which Accomplish the Stated Objectives of Applicable Statutes and Which Minimize Any Significant Economic Impact of the Final Rule on Small Entities

While the Department considered alternative means of satisfying many specific provisions, as discussed in the Analysis of Comments and Changes to this final rule, there are no other significant alternatives that would satisfy the same legal and policy objectives while minimizing the impact on small entities. *The factual, policy, and legal reasons for selecting the alternative adopted in the final rule.*

The adopted approach balances regulatory reform values and improved accountability in a reasonable fashion. Consistent with the Secretary's Regulatory Relief Initiative, participating institutions are subject to the minimum requirements that adequately protect the Federal fiscal interest. A substantial number of institutions will experience a reduced regulatory burden as a result of these rules. The Secretary believes that the proposed approach is the least complicated and burdensome for small (and large) entities involved in the administration of the title IV, HEA programs while still allowing for the proper protection of the Federal fiscal interest and the interests of students and their parents.

For the purposes of performing this regulatory flexibility analysis, the alternative of "no action" could be considered a significant alternative. If the Secretary did not undertake any action in this area, small (and large) entities would not experience the economic impacts imposed by this regulation. However, as described in the preamble to this final rule, the Secretary believes that this action is required to further Department initiatives and to better protect the Federal fiscal interest. This is discussed further in the next section.

Why Each One of the Other Significant Alternatives to the Rule Considered by the Department Which Affect the Impact on Small Entities Was Rejected

The Department considered many alternatives to this rule. Significant alternatives that were considered but determined not to meet the policy objectives are discussed in the next section. The policy objectives for this rule are discussed at length in the preamble. These various alternatives might have had an effect on the impact on small entities to the degree that they might have led to a different result from

the ratio test. Some of these alternatives are discussed at greater length elsewhere in the Analysis of Comments and Changes.

Case-by-Case Precipitous Closure Alternative

The Department considered performing a case-by-case analysis of institutions that marginally failed the regulatory standard (*i.e.*, the composite score standard) to determine if they were in danger of closing precipitously. This alternative was rejected for several reasons. This alternative would have required significantly more resources than the Department has available for such an activity and would have been difficult to enforce. This alternative could have conceivably reduced the impact on small entities, if there was additional information not available in the ratio approach that would have led an individualized analysis to determine that the institution was not in danger of precipitously closing. However, the fairness of such a system could be suspect and the policy goal of having a fair rule that is known and consistently applied would have been undermined. In addition, the Secretary believes that the ratio analysis takes the total financial condition into account, so that it would be an exceedingly rare event for an institution with a very low score to have sufficient financial strength to warrant continued participation. The zone alternative chosen employs as much case-by-case treatment as the Department considers appropriate and manageable. The alternative chosen gives the case management teams some discretion with regard to the stringency of the additional monitoring that will be required.

Continuous Improvement Zone Alternative

The Department considered requiring institutions to demonstrate continuous improvement to be eligible to use the zone alternative. This alternative was rejected for several reasons. In such a system, an institution would be required to have a score that was continuously rising. For instance, an institution with a score of 1.1 would have to score higher in the subsequent year in order to be able to use the zone alternative in a second year. The Secretary believes that the final score accurately reflects the institution's financial health. A continuous improvement model would mean, for instance, that two institutions with a score of 1.3 would be treated differently depending on their scores the previous year. An institution with a score of 1.3 in the current year that scored a 1.0 the previous year would

have demonstrated improvement while the institution that scored 1.3 in both years would not have demonstrated improvement, leading to different regulatory results. The policy goal of treating institutions in a similar situation equitably would not have been satisfied if a continuous improvement model were chosen. The zone alternative chosen does require institutions to demonstrate improvement, in that institutions must score at or above the regulatory standard by the end of the third year. In addition, this option would add to the complexity of administering the rule.

Secondary Analysis

The Department considered various types of secondary analysis for institutions that marginally failed the ratio test. One type of secondary analysis that was considered was to calculate some additional ratios and assign bonus points for institutions with high values in these additional ratios. These alternatives were rejected for several reasons. Extensive analysis of the audited financial statements did not uncover any additional ratios that provided sufficient useful information about an institution's financial condition, such as the secondary reserve ratio or a ratio of equity to expenses. Other ratios were rejected because they lent themselves to manipulation, such as cash flow ratios or current ratios. Some ratios were rejected because they could not be calculated for all institutions, such as the Viability ratio or a debt service ratio.

Personal Financial Guarantees

The Department considered allowing institutions to demonstrate financial responsibility by providing personal financial guarantees at their option. This alternative was proposed in the NPRM, but rejected for several reasons. This proposed alternative was not considered to be desirable by the community. The resources that the Department would have devoted to administering this alternative were determined to be better employed in managing the zone alternative.

Requiring Institutions Only To Pass the Ratio Test for Most Years

The Department considered a methodology by which institutions would have only been required to pass the ratio test in two of three years, or in three of four years. This alternative was rejected for several reasons. Such a methodology would have allowed an institution to marginally pass for two years, while failing miserably the third year. However, an analysis of data of

closed institutions indicates that institutions that fail the ratio test should not be allowed to continue to participate without some additional surety to protect the Federal interest.

Analysis of Information Not on General Purpose Audited Financial Statements

The Department considered including information that was not available on audited financial statements. This alternative was rejected for several reasons. The Department does not have sufficient resources to determine the veracity of unaudited information that institutions would have provided under this alternative, such as enrollment data or similar types of information. The Department did consider requiring certain types of information that could have been attested to by the institution's auditor and disclosed in a note to the audited financial statement. KPMG advised the Department about the types of information that could be audited, and it was determined that the types of information that could have been attained using this method, combined with the difficulties in implementing a note disclosure, would not provide sufficient additional information beyond that contained in the ratio methodology chosen.

Conclusion

The Secretary concludes that a substantial number of small entities are likely to experience significant adverse economic impacts from the proposed rule, offset by significant positive economic effects on a slightly smaller number of small entities. As discussed in the section referring to the cost-benefit assessment of this proposed rule pursuant to Executive Order 12866, the Secretary has concluded that the costs are justified by the benefits. In this case, the benefits are reduced Federal fiscal liabilities as well as improved service to students participating in the title IV, HEA programs.

Paperwork Reduction Act of 1995

Sections 668.171(c), 668.172(c)(5), 668.174(b)(2)(i), 668.175(d)(2)(ii), 668.175(f)(2)(iii), and 668.175(g)(2)(i) contain information collection requirements. As required by the Paperwork Reduction Act of 1995, the U.S. Department of Education has submitted a copy of these sections to OMB for its review. (44 U.S.C. 3504(h)).

Assessment of Educational Impact

In the NPRM published September 20, 1996, the Secretary requested comment on whether the proposed regulations in this document would require transmission of information that is being

gathered by, or is available from, any other agency or authority of the United States.

Based on the response to the proposed rules on its own review, the Department has determined that the regulations in this document do not require transmission of information that is being gathered by, or is available from, any other agency or authority of the United States.

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List of Subjects in 34 CFR Part 668

Administrative practice and procedure, Colleges and universities, Student aid, Reporting and recordkeeping requirements.

Dated: November 14, 1997.

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 amends 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.

Subpart B—Standards for Participation in the Title IV, HEA Programs

§ 668.13 [Amended]

2. Section 668.13 is amended by removing paragraphs (d) and (e), and by redesignating paragraph (f) as paragraph (d).

§ 668.23 [Amended]

3. Section 668.23 is amended by removing paragraph (f) and redesignating paragraphs (g) and (h) as paragraphs (f) and (g), respectively.

Subpart K—Cash Management

4. Section 668.162 is amended by revising paragraph (a)(1), and by adding a new paragraph (e) to read as follows:

§ 668.162 Requesting funds.

(a) *General.* (1) The Secretary has sole discretion to determine the method under which the Secretary provides title IV, HEA program funds to an institution. In accordance with procedures established by the Secretary, the Secretary may provide funds to an institution under the advance, reimbursement, just-in-time, or cash monitoring payment methods.

* * * * *

(e) *Cash monitoring payment method.* Under the cash monitoring payment method, the Secretary provides title IV, HEA program funds to an institution under the provisions described in paragraph (e)(1) or (e)(2) of this section. Under either paragraph (e)(1) or (e)(2) of this section, an institution must first make disbursements to students and parents for the amount of title IV, HEA program funds that those students and parents are eligible to receive, before the institution—

(1) Submits a request for funds under the provisions of the advance payment method described in paragraph (b) of this section, except that the institution's request may not exceed the amount of the actual disbursements the institution made to the students and parents included in that request; or

(2) Seeks reimbursement for those disbursements under the provisions of the reimbursement payment method described in paragraph (d) of this section, except that the Secretary may modify the documentation requirements and review procedures used to approve the reimbursement request.

5. Section 668.167 is amended by adding a new paragraph (f) to read as follows:

§ 668.167 FFEL program funds.

* * * * *

(f) *An institution placed under the cash monitoring payment method.* The Secretary may require an institution that is placed under the cash monitoring described under paragraph § 668.162(e), to comply with the disbursement and certification provisions under paragraph (d) of this section, except that the Secretary may modify the documentation requirements and review procedures used to approve the institution's disbursement or certification request.

6. A new subpart L is added to read as follows:

Subpart L—Financial Responsibility

Sec.

- 668.171 General.
- 668.172 Financial ratios.
- 668.173 Refund reserve standards.
- 668.174 Past performance.
- 668.175 Alternative standards and requirements.

§ 668.171 General.

(a) Purpose. 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. As provided under section 498(c)(1) of the HEA, the Secretary determines whether an institution is financially responsible based on the institution's ability to—

- (1) Provide the services described in its official publications and statements;
- (2) Administer properly the title IV, HEA programs in which it participates; and
- (3) Meet all of its financial obligations.

(b) *General standards of financial responsibility.* Except as provided under paragraphs (c) and (d) of this section, the Secretary considers an institution to be financially responsible if the Secretary determines that—

(1) The institution's Equity, Primary Reserve, and Net Income ratios yield a composite score of at least 1.5, as provided under § 668.172 and Appendices F and G;

(2) The institution has sufficient cash reserves to make required refunds, as provided under § 668.173;

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

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

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

(i) Refunds that it is required to make under § 668.22; and

(ii) Repayments to the Secretary for debts and liabilities arising from the institution's participation in the title IV, HEA programs.

(c) *Public institutions.* The Secretary considers a public institution to be financially responsible if the institution—

- (1)(i) Notifies the Secretary that it is designated as a public institution by the State, local or municipal government entity, tribal authority, or other government entity that has the legal authority to make that designation; and
- (ii) Provides a letter from an official of that State or other government entity confirming that the institution is a public institution; and
- (2) Is not in violation of any past performance requirement under § 668.174.

(d) *Audit opinions and past performance provisions.* Even if an institution satisfies all of the general standards of financial responsibility under paragraph (b) of this section, the Secretary does not consider the institution to be financially responsible if—

(1) In the institution's audited financial statements, the opinion expressed by the auditor was an adverse, qualified, or disclaimed opinion, or the auditor expressed doubt about the continued existence of the institution as a going concern, unless the Secretary determines that a qualified or disclaimed opinion does not have a significant bearing on the institution's financial condition; or

(2) As provided under the past performance provisions in § 668.174(a)

and (b)(1), the institution violated a title IV, HEA program requirement, or the persons or entities affiliated with the institution owe a liability for a violation of a title IV, HEA program requirement.

(e) *Administrative actions.* If the Secretary determines that an institution is not financially responsible under the standards and provisions of this section or under an alternative standard in § 668.175, or the institution does not submit its financial and compliance audits by the date permitted and in the manner required under § 668.23, the Secretary may—

(1) Initiate an action under subpart G of this part to fine the institution, or limit, suspend, or terminate the institution's participation in the title IV, HEA programs; or

(2) For an institution that is provisionally certified, take an action against the institution under the procedures established in § 668.13(d).

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

§ 668.172 Financial ratios.

(a) *Appendices F and G, ratio methodology.* As provided under Appendices F and G to this part, the Secretary determines an institution's composite score by—

- (1) Calculating the result of its Primary Reserve, Equity, and Net Income ratios, as described under paragraph (b) of this section;
- (2) Calculating the strength factor score for each of those ratios by using the corresponding algorithm;
- (3) Calculating the weighted score for each ratio by multiplying the strength factor score by its corresponding weighting percentage;
- (4) Summing the resulting weighted scores to arrive at the composite score; and
- (5) Rounding the composite score to one digit after the decimal point.

(b) *Ratios.* The Primary Reserve, Equity, and Net Income ratios are defined under Appendix F for proprietary institutions, and under Appendix G for private non-profit institutions.

(1) The ratios for proprietary institutions are:

For proprietary institutions:

$$\text{Primary Reserve ratio} = \frac{\text{Adjusted Equity}}{\text{Total Expenses}}$$

$$\text{Equity ratio} = \frac{\text{Modified Equity}}{\text{Modified Assets}}$$

$$\text{Net Income ratio} = \frac{\text{Income Before Taxes}}{\text{Total Revenues}}$$

(2) The ratios for private non-profit institutions are:

$$\text{Primary Reserve ratio} = \frac{\text{Expendable Net Assets}}{\text{Total Expenses}}$$

$$\text{Equity Ratio} = \frac{\text{Modified Net Assets}}{\text{Modified Assets}}$$

$$\text{Net Income ratio} = \frac{\text{Change in Unrestricted Net Assets}}{\text{Total Unrestricted Revenues}}$$

(c) *Excluded items.* In calculating an institution's ratios, the Secretary—

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

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

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

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

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

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

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

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

§ 668.173 Refund reserve standards.

(a) *General.* The Secretary considers that an institution has sufficient cash reserves (as required under § 668.171(b)(2)) to make any refunds required under § 668.22 if the institution—

(1) Satisfies the requirements of a public institution under § 668.171(c)(1);

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

(3) Demonstrates that it makes its refunds timely, as provided under paragraph (b) of this section.

(b) *Timely refunds.* An institution demonstrates that it makes required refunds within the time permitted under § 668.22 if the auditor(s) who conducted the institution's compliance audits for the institution's two most recently completed fiscal years, or the Secretary or a State or guaranty agency that conducted a review of the institution covering those fiscal years—

(1) Did not find in the sample of student records audited or reviewed for either of those fiscal years that—

(i) The institution made late refunds to 5 percent or more of the students in that sample. For purposes of determining the percentage of late refunds under this paragraph, the auditor or reviewer must include in the sample only those title IV, HEA program recipients who received or should have received a refund under § 668.22; or

(ii) The institution made only one late refund to a student in that sample; and

(2) Did not note for either of those fiscal years a material weakness or a reportable condition in the institution's report on internal controls that is related to refunds.

(c) *Refund findings.* Upon a finding that an institution no longer satisfies a refund standard under paragraph (a)(1) or (2) of this section, or that the institution is not making its refunds timely under paragraph (b) of this section, the 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 the institution made or should have made during its most recently completed fiscal year. The institution must submit this letter of credit to the Secretary no later than—

(1) Thirty days after the date the institution is required to submit its compliance audit to the Secretary under § 668.23, if the finding is made by the auditor who conducted that compliance audit; or

(2) Thirty days after the date that the Secretary, or the State or guaranty agency that conducted a review of the institution notifies the institution of the finding. The institution must also notify the Secretary of that finding and of the State or guaranty agency that conducted that review of the institution.

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

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

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

(3) 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)

§ 668.174 Past performance.

(a) *Past performance of an institution.* An institution is not financially responsible if the institution—

(1) 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;

(2) In either of its two most recent compliance audits had an audit finding, or in a report issued by the Secretary had a program review finding for its current fiscal year or either of its preceding two fiscal years, that resulted in the institution's being required to repay an amount greater than 5 percent of the funds that the institution received under the title IV, HEA programs during the year covered by that audit or program review;

(3) Has been cited during the preceding five years for failure to submit in a timely fashion acceptable compliance and financial statement audits required under this part, or acceptable audit reports required under the individual title IV, HEA program regulations; or

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

(b) *Past performance of persons affiliated with an institution.* (1)(i) Except as provided under paragraph (b)(2) of this section, an institution is not financially responsible if a person who exercises substantial control over the institution, as described under 34 CFR 600.30, or any member or members of that person's family, alone or together—

(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.

(2) The Secretary may determine that an institution is financially responsible, even if the institution is not otherwise financially responsible under paragraph (b)(1) of this section, if—

(i) The institution notifies the Secretary, within the time permitted and in the manner provided under 34 CFR 600.30, that the person referenced in paragraph (b)(1) of this section exercises substantial control over the institution; and

(ii) The person referenced in paragraph (b)(1) of this section 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, 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; or

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

(iv) The institution demonstrates to the satisfaction of the Secretary 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, an 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 entirety;

(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 a 20 percent ownership interest in the institution or servicer;

(ii) Holds, together with other members of his or her family, at least a 20 percent ownership 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.

(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)

§ 668.175 Alternative standards and requirements.

(a) *General.* An institution that is not financially responsible under the general standards and provisions in § 668.171, may begin or continue to participate in the title IV, HEA programs by qualifying under an alternate standard set forth in this section.

(b) *Letter of credit alternative for new institutions.* A new institution that is not financially responsible solely because the Secretary determines that its composite score is less than 1.5, qualifies as a financially responsible institution by submitting an irrevocable letter of credit, that is acceptable and payable to the Secretary, for an amount equal to 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 new institution is an institution that seeks to participate for the first time in the title IV, HEA programs.

(c) *Letter of credit alternative for participating institutions.* A

participating institution that is not financially responsible either because it does not satisfy one or more of the standards of financial responsibility under § 668.171(b), or because of an audit opinion described under § 668.171(d), qualifies as a financially responsible institution by submitting an irrevocable letter of credit, that is acceptable and payable to the Secretary, for an amount determined by the Secretary that is not less than one-half of the title IV, HEA program funds received by the institution during its most recently completed fiscal year.

(d) *Zone alternative.* (1) A participating institution that is not financially responsible solely because the Secretary determines that its composite score is less than 1.5 may participate in the title IV, HEA programs as a financially responsible institution for no more than three consecutive years, beginning with the year in which the Secretary determines that the institution qualifies under this alternative. (i)(A) An institution qualifies initially under this alternative if, based on the institution's audited financial statement for its most recently completed fiscal year, the Secretary determines that its composite score is in the range from 1.0 to 1.4; and

(B) An institution continues to qualify under this alternative if, based on the institution's audited financial statement for each of its subsequent two fiscal years, the Secretary determines that the institution's composite score is in the range from 1.0 to 1.4.

(ii) An institution that qualified under this alternative for three consecutive years or for one of those years, may not seek to qualify again under this alternative until the year after the institution achieves a composite score of at least 1.5, as determined by the Secretary.

(2) Under this zone alternative, the Secretary—

(i) Requires the institution to make disbursements to eligible students and parents under either the cash monitoring or reimbursement payment method described in § 668.162;

(ii) Requires the institution to provide timely information regarding any of the following oversight and financial events—

(A) Any adverse action, including a probation or similar action, taken against the institution by its accrediting agency;

(B) Any event that causes the institution, or related entity as defined in the Statement of Financial Accounting Standards (SFAS) 57, to realize any liability that was noted as a contingent liability in the institution's

or related entity's most recent audited financial statement;

(C) Any violation by the institution of any loan agreement;

(D) Any failure of the institution to make a payment in accordance with its debt obligations that results in a creditor filing suit to recover funds under those obligations;

(E) Any withdrawal of owner's equity from the institution by any means, including by declaring a dividend; or

(F) Any extraordinary losses, as defined in accordance with Accounting Principles Board (APB) Opinion No. 30.

(iii) May require the institution to submit its financial statement and compliance audits earlier than the time specified under § 668.23(a)(4); and

(iv) May require the institution to provide information about its current operations and future plans.

(3) Under the zone alternative, the institution must—

(i) For any oversight or financial event described under paragraph (d)(2)(ii) of this section for which the institution is required to provide information, provide that information to the Secretary by certified mail or electronic or facsimile transmission no later than 10 days after that event occurs. An institution that provides this information electronically or by facsimile transmission is responsible for confirming that the Secretary received a complete and legible copy of that transmission; and

(ii) As part of its compliance audit, require its auditor to express an opinion on the institution's compliance with the requirements under the zone alternative, including the institution's administration of the payment method under which the institution received and disbursed title IV, HEA program funds.

(4) If an institution fails to comply with the requirements under paragraphs (d)(2) or (3) of this section, the Secretary may determine that the institution no longer qualifies under this alternative.

(e) *Transition year alternative.* A participating institution that is not financially responsible solely because the Secretary determines that its composite score is less than 1.5 for the institution's fiscal year that began on or after July 1, 1997 but on or before June 30, 1998, may qualify as a financially responsible institution under the provisions in § 668.15(b)(7), (b)(8), (d)(2)(ii), or (d)(3), as applicable.

(f) *Provisional certification alternative.* (1) The Secretary may permit an institution that is not financially responsible to participate in the title IV, HEA programs under a

provisional certification for no more than three consecutive years if—

(i) The institution is not financially responsible because it does not satisfy the general standards under § 668.171(b) or because of an audit opinion described under § 668.171(d); or

(ii) The institution is not financially responsible because of a condition of past performance, as provided under § 668.174(a), and the institution demonstrates to the Secretary that it has satisfied or resolved that condition.

(2) Under this alternative, the institution must—

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

(ii) Demonstrate that it was current on its debt payments and has met all of its financial obligations, as required under § 668.171(b)(3) and (b)(4), for its two most recent fiscal years; and

(iii) Comply with the provisions under the zone alternative, as provided under paragraph (d)(2) and (3) of this section.

(3) If at the end of the period for which the Secretary provisionally certified the institution, the institution is still not financially responsible, the Secretary may again permit the institution to participate under a provisional certification, but the Secretary—

(i) May require the institution, or one or more persons or entities that exercise substantial control over the institution, as determined under § 668.174(d), or both, to submit to the Secretary financial guarantees for an amount determined by the Secretary to be sufficient to satisfy any potential liabilities that may arise from the institution's participation in the title IV, HEA programs; and

(ii) May require one or more of the persons or entities that exercise substantial control over the institution, as determined under § 668.174(d), to be jointly or severally liable for any liabilities that may arise from the institution's participation in the title IV, HEA programs.

(g) *Provisional certification alternative for persons or entities owing liabilities.*

(1) The Secretary may permit an institution that is not financially responsible because the persons or entities that exercise substantial control over the institution owe a liability for a violation of a title IV, HEA program requirement, to participate in the title

IV, HEA programs under a provisional certification only if—

(i)(A) The persons or entities that exercise substantial control, as determined under § 668.174(d), repay or enter into an agreement with the Secretary to repay the applicable portion of that liability, as provided under § 668.174(c)(2)(ii); or

(B) The institution assumes that liability, and repays or enters into an agreement with the Secretary to repay that liability;

(ii) The institution satisfies the general standards and provisions of financial responsibility under § 668.171 (b) and (d), except that institution must demonstrate that it was current on its debt payments and has met all of its

financial obligations, as required under § 668.171(b)(3) and (b)(4), for its two most recent fiscal years; and

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

(2) Under this alternative, the Secretary—

(i) Requires the institution to comply with the provisions under the zone alternative, as provided under paragraph (d)(2) and (3) of this section;

(ii) May require the institution, or one or more persons or entities that exercise

substantial control over the institution, or both, to submit to the Secretary financial guarantees for an amount determined by the Secretary to be sufficient to satisfy any potential liabilities that may arise from the institution's participation in the title IV, HEA programs; and

(iii) May require one or more of the persons or entities that exercise substantial control over the institution to be jointly or severally liable for any liabilities that may arise from the institution's participation in the title IV, HEA programs.

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

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7. A new Appendix F is added to read as follows:

Appendix F: Ratio Methodology for Proprietary Institutions
Section 1: Ratios and Ratio Terms

$$\text{Primary Reserve Ratio} = \frac{\text{Adjusted Equity}}{\text{Total Expenses}}$$

$$\text{Equity Ratio} = \frac{\text{Modified Equity}}{\text{Modified Assets}}$$

$$\text{Net Income Ratio} = \frac{\text{Income Before Taxes}}{\text{Total Revenues}}$$

Definitions:

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

Total Expenses excludes income tax, discontinued operations, extraordinary losses, or change in accounting principle.

Modified Equity = (total owner's equity) - (intangible assets) - (unsecured related-party receivables)

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

Income Before Taxes is taken directly from the audited financial statement

Total Pre-Tax Revenues = (total operating revenues) + (non-operating revenues and gains). Investment gains should be recorded net of investment losses. No revenues shown after income taxes (e.g., discontinued operations, extraordinary gains, or change in accounting principle) on the income statement should be included.

* The value of plant, property and equipment is net of accumulated depreciation, including capitalized lease assets.

** The value of all debt obtained for long-term purposes includes the short-term portion of the debt, up to the amount of net property, plant and equipment.

Section 2, Calculating the Ratios from the Balance Sheet and Income Statement

Balance Sheet

Line	Description	Amount
1	Cash	\$ 190,000
2	Accounts Receivable	1,010,000
3	Prepaid Expenses	150,000
4	Inventories	130,000
5	Note Receivable from Affiliate	200,000
6	Investments	330,000
7	Total Current Assets	2,010,000
8	Property and Equipment, net	500,000
9	Amount Due from Owner	170,000
10	Goodwill	80,000
11	Organization Costs	70,000
12	Deposits	60,000
13	Total Assets	2,890,000
14	Accounts Payable	200,000
15	Accrued Expenses	330,000
16	Current Portion of Long-Term Debt	120,000
17	Deferred Revenue	650,000
18	Total Current Liabilities	1,300,000
19	Long-Term Debt, net of Current Portion	330,000
20	Total Liabilities	1,630,000
21	Contributed Capital	440,000
22	Retained Earnings	820,000
23	Total Owner's Equity	1,260,000
24	Total Liabilities and Owner's Equity	2,890,000

Statement of Income and Retained Earnings

Line	Description	Amount
25	Operating Income	\$ 9,700,000
26	Non-Operating Income	300,000
27	Total Income	10,000,000
28	Cost of Goods Sold	6,800,000
29	Administrative Expenses	2,600,000
30	Depreciation Expense	60,000
31	Interest Expense	40,000
32	Total Expenses	9,500,000
33	Other: Gain on Sale of Investments	10,000
34	Net Income Before Taxes	510,000
35	Federal Income Taxes	153,000
36	Net Income After Taxes	357,000
37	Extraordinary Loss, net of tax	800,000
38	Net Income	(443,000)
39	Retained Earnings, beginning of year	1,263,000
22	Retained Earnings, end of year	820,000

$$\text{Primary Reserve Ratio} = \frac{\text{(lines) } 23-5-9-10-8+(16+19)^*}{32} = \frac{\$ 760,000}{\$ 9,500,000} = 0.080$$

$$\text{Equity Ratio} = \frac{\text{(lines) } 23-5-9-10}{13-5-9-10} = \frac{\$ 810,000}{\$ 2,440,000} = 0.332$$

$$\text{Net Income Ratio} = \frac{\text{(lines) } 34}{27+33} = \frac{\$ 510,000}{\$ 10,010,000} = 0.051$$

*Long-Term Debt (lines 16 + 19) cannot exceed Property and Equipment (line 8) in this formula

Section 3: Calculating the Composite Score

Step 1: Calculate the strength factor score for each ratio, by using the following algorithms:

Example (for Proprietary institutions)

$$20 \times 0.080 = 1.600$$

$$6 \times 0.332 = 1.992$$

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

Primary Reserve strength factor score = $20 \times$ Primary Reserve ratio result:

Equity strength factor score = $6 \times$ Equity ratio result:

Net Income strength factor score = $1 + (33.3 \times$ Net Income ratio result):

If the strength factor score for any ratio is greater than or equal to 3, the strength factor score for that ratio is 3. If the strength factor score for any ratio is less than or equal to -1, the strength factor score for that ratio is -1.

Step 2: Calculate the weighted score for each ratio and calculate the composite score by adding the three weighted scores

Primary Reserve weighted score = $30\% \times$ Primary Reserve strength factor score: $0.30 \times 1.600 = 0.480$

Equity weighted score = $40\% \times$ Equity strength factor score: $0.40 \times 1.992 = 0.797$

Net Income weighted score = $30\% \times$ Net Income strength factor score: $0.30 \times 2.698 = 0.809$

Composite score = sum of all weighted scores: $0.480 + 0.797 + 0.809 = 2.086$

Round the composite score to one digit after the decimal point to determine the final score: 2.1

* The symbol "x" denotes multiplication.

8. A new Appendix G is added to read as follows:

Appendix G: Ratio Methodology for Private Non-Profit Institutions
Section 1: Ratios and Ratio Terms

Primary Reserve Ratio = $\frac{\text{Expendable Net Assets}}{\text{Total Expenses}}$

Equity Ratio = $\frac{\text{Modified Net Assets}}{\text{Modified Assets}}$

Net Income Ratio = $\frac{\text{Change in Unrestricted Net Assets}}{\text{Total Unrestricted Revenue}}$

Definitions:

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

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

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

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

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

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

* The value of plant, property and equipment is net of accumulated depreciation, including capitalized lease assets.

** The value of all debt obtained for long-term purposes includes the short-term portion of the debt, up to the amount of net property, plant and equipment.

Section 2, Calculating the Ratios from the Balance Sheet and Statement of Activities
 Balance Sheet
 Statement of Activities
 column: a

Line	Total
1	Cash and Cash Equivalents \$ 1,000,000
2	Accounts Receivable 6,000,000
3	Prepaid Expenses 1,500,000
4	Inventories 500,000
5	Contributions Receivable 2,000,000
6	Student Loans Receivable 8,000,000
7	Investments 6,000,000
8	Property and Equipment, net 50,000,000
9	Bond Insurance Costs 720,000
10	Goodwill 500,000
11	Deposits 20,000
12	Total Assets 76,240,000
13	Line of Credit \$ 500,000
14	Accounts Payable 2,000,000
15	Accrued Expenses 3,500,000
16	Deferred Revenue 650,000
17	Post-Retirement Benefits Liability 6,600,000
18	Bonds Payable 36,000,000
19	Total Liabilities 49,250,000
20	Unrestricted Net Assets 15,190,000
21	Annuities 300,000
22	John Doe Scholarship Fund 2,500,000
23	Total Temp. Restricted Net Assets 2,800,000
24	Permanent Restr. Net Assets 9,000,000
25	Total Net Assets 26,990,000
26	Total Liabilities & Net Assets 76,240,000

Line	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
27	Tuition and Fees \$45,000,000			\$45,000,000
28	Contributions 1,200,000	\$ 300,000	\$ 120,000	1,620,000
29	Auxiliary Enterprises 5,500,000			5,500,000
30	Net Assets Released from Restrictions 200,000			200,000
31	Total Revenue 51,900,000	300,000	120,000	52,320,000
32	Operating Expenses 38,000,000			38,000,000
33	Depreciation 5,000,000			5,000,000
34	Interest Expense 2,880,000			2,880,000
35	Auxiliary Enterprises 5,200,000			5,200,000
36	Non-Operating Expenses 900,000			900,000
37	Net Assets Released from Restrictions	200,000	---	200,000
38	Total Expenses 51,980,000	200,000	---	52,180,000
39	Change in Net Assets (80,000)*	100,000	120,000	140,000
40	Net Assets at beginning of year 15,270,000	2,700,000	8,880,000	26,850,000
41	Net Assets at end of year 15,190,000	2,800,000	9,000,000	26,990,000

Primary Reserve Ratio = (lines) $\frac{20+23-21-10-8+18}{38} = \frac{\$ 9,790,000}{51,980,000} = 0.188$

Equity Ratio = (lines) $\frac{25-10}{12-10} = \frac{\$26,490,000}{75,740,000} = 0.350$

Net Income Ratio = (lines) $\frac{32a}{31a} = \frac{\$ (80,000)}{51,900,000} = (0.0015)$

* In accounting statements, parentheses denote negative numbers (i.e., (80,000) equals negative 80,000).

** Long-Term Debt (line 18) cannot exceed Property and Equipment, net (line 8) in this formula.

Section 3: Calculating the Composite Score

Step 1: Calculate the strength factor score for each ratio, by using the following algorithms

Primary Reserve strength factor score = $10 \times$ Primary Reserve ratio result:
Example (for Private Non-Profit institutions)
 $10 \times 0.188 = 1.880$

Equity strength factor score = $6 \times$ Equity ratio result:
 $6 \times 0.350 = 2.100$

Because the Net Income ratio result is negative, the algorithm for negative net income is used -- Net Income strength factor score = $1 + (25 \times$ Net Income ratio result):
 $1 + (25 \times -0.0015) = 0.963$

(Note: If the Net Income ratio result is positive, the following algorithm is used, Net Income strength factor score = $1 + (50 \times$ Net Income ratio result) -- If the Net Income ratio result is 0, the Net Income strength factor score is 1).

If the strength factor score for any ratio is greater than or equal to 3, the strength factor score for that ratio is 3. If the strength factor score for any ratio is less than or equal to -1, the strength factor score for that ratio is -1.

Step 2: Calculate the weighted score for each ratio and calculate the composite score by adding the three weighted scores

Primary Reserve weighted score = $40\% \times$ Primary Reserve strength factor score: $0.40 \times 1.880 = 0.752$

Equity weighted score = $40\% \times$ Equity strength factor score: $0.40 \times 2.100 = 0.840$

Net Income weighted score = $20\% \times$ Net Income strength factor score: $0.20 \times 0.963 = 0.193$

Composite score = sum of all weighted scores: $0.752 + 0.840 + 0.193 = 1.785$

Round the composite score to one digit after the decimal point to determine the final score: 1.8

* The symbol "x" denotes multiplication.