

SESSION # 11

Regulatory Update, Financial Responsibility

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FINANCIAL RESPONSIBILITY UPDATE

Major Changes

Triggering Events

- Removed pending lawsuits and other events where the amount of the liability was speculative
- Revised other events

Composite Score

- Updated to reflect recent changes in accounting standards
- Revised definition of terms
- Supplemental Schedule

FINANCIAL RESPONSIBILITY UPDATE

Additional Information

NPRM: <https://ifap.ed.gov/federal-registers/07-31-2018-subject-notice-proposed-rulemaking-institutional-accountability>

FINAL: <https://ifap.ed.gov/federal-registers/fr092319>

ELECTRONIC ANNOUNCEMENT:

<https://ifap.ed.gov/electronic-announcements/040920FinancialResponsibilityQuestionsAnswers>

FINANCIAL RESPONSIBILITY UPDATE

Triggering Events

- An action or event that occurs during an institution's fiscal year that may have an adverse impact on the institution's financial condition

Types of triggering events

- Mandatory triggers: presumption that the action or event has or will have an adverse impact, unless the institution demonstrates otherwise
- Discretionary triggers: Department shows the actions or events have an adverse impact

If two or more unresolved discretionary triggers occur within the fiscal year, they become mandatory triggers.

FINANCIAL RESPONSIBILITY UPDATE

Triggering Events

Mandatory

- A liability from a settlement, final judgment, or determination arising from an administrative or judicial action or proceeding initiated by a federal or state entity
 - Previously, pending lawsuits from any party
- Withdrawal of Owner's Equity – only for a proprietary institutions whose composite score is less than 1.5
 - Same as before, but the regulations now describe what constitutes a withdrawal of owner's equity

FINANCIAL RESPONSIBILITY UPDATE

Triggering Events – Mandatory

- SEC or national securities exchange violations – only for publicly traded institutions
 - Previously, warning from the SEC that it may suspend trading on the institution's stock
- Removed Gainful Employment trigger

FINANCIAL RESPONSIBILITY UPDATE

Triggering Events - Mandatory

Department Actions

- For final liabilities or withdrawals, the composite score is recalculated.
- If the recalculated score is less than 1.0, the institution must provide financial protection.

FINANCIAL RESPONSIBILITY UPDATE

Triggering Events - Discretionary

- An accrediting agency action (show cause, probation or similar) that could result in the withdrawal, revocation, or suspension of an institution's accreditation
 - Previously, a mandatory trigger if the institution was required by its accrediting agency to submit a teach-out plan
- A violation of a provision or requirement in a security or loan agreement with a creditor
 - No changes
- A violation of a state licensing or authorizing agency requirement for which the agency intends to withdraw or terminate the institution's licensure or authorization
 - Previously, any failure by the institution to meet state or agency requirements

FINANCIAL RESPONSIBILITY UPDATE

Triggering Events - Discretionary

- Failure to satisfy the 90/10 revenue requirements – only for proprietary institutions.
 - Previously, a mandatory trigger
- An institution's two most recent cohort default rates are 30 percent or greater, unless the institution successfully challenges or appeals either or both rates
 - Previously, a mandatory trigger
- An institution has high annual drop-out rates
 - No change

FINANCIAL RESPONSIBILITY UPDATE

Triggering Events

Discretionary – Removed Triggers

- Fluctuations in Direct Loan and Pell Grant funding
- Stress Test
- Pending or expected borrower defense claims

FINANCIAL RESPONSIBILITY UPDATE

Department Actions/Process

- Typically, the institution is required to report a triggering event no later than 10 days after it occurs.
- When it reports the event, or in response to a preliminary determination that the institution is not financially responsible, the institution may:
 1. Demonstrate the withdrawal of equity was used exclusively to meet tax liabilities;
 2. Show that the creditor waived a violation of a loan agreement;
 3. Show that the triggering event has been resolved or that it has insurance that will cover all or part of the liability; and
 4. Provide information about the circumstances precipitating the trigger that shows the event will not have an adverse effect on the institution.

FINANCIAL RESPONSIBILITY UPDATE

Leases as a Result of Accounting Changes in ASU 2016-02

- ASU 2016-02 created a new lease right-of-use asset that would be valued at implementation of the requirement and a corresponding liability to be included in an institution's Balance Sheet.
- An institution not required to implement the lease reporting requirement identified in ASU 2016-02 will continue to report its lease obligations as it currently does, and there will be no change in the calculation of the composite score under the final regulations until the institution is required to report leases as required in ASU 2016-02.

FINANCIAL RESPONSIBILITY UPDATE

Leases as a Result of Accounting Changes in ASU 2016-02

- To recognize that institutions had made business decisions prior to the change in lease reporting, the Department created two classes of leases for the composite score calculation – **Pre-implementation Leases** and **Post-Implementation Leases**.
 - **Pre-implementation Leases** are those leases entered into prior to December 15, 2018.
 - **Post-implementation Leases** are any leases entered into on or after December 15, 2018.
- **Pre-implementation Leases** will be treated as leases were treated for the composite score prior to ASU-2016-02, provided the institution supplies sufficient information in the Supplemental Schedule, in the Notes to the Financial Statements, or on the face of the Financial Statement. **Post-Implementation Leases** will be treated as capital leases are currently treated.

FINANCIAL RESPONSIBILITY UPDATE

Leases as a Result of Accounting Changes in ASU 2016-02

- If an institution does not provide the information needed to identify Pre-Implementation Leases, the Department will conclude that the institution does not wish to have the Pre-implementation Leases considered for the composite score and that decision is final.
- Under ASU 2016-02, **Pre-implementation Leases cannot increase once an institution is required to report leases.** For example, once the lease right-of-use asset and corresponding liability have been valued on implementation, the institution cannot later decide to include options in the value of the right-of-use asset that were not considered on implementation. If the value of a Pre-implementation Lease goes up, it becomes a Post-Implementation Lease. Pre-implementation Leases will eventually be zero.

FINANCIAL RESPONSIBILITY UPDATE

Changes to the Treatment of Debt Obtained for Long-term Purposes

- The Final Regulation effectively rescinds Dear Colleague Letter Gen-03-08, which allowed favorable treatment in the primary reserve ratio for all debt obtained for long-term purposes.
- Generally, in calculating a primary reserve ratio for evaluating an entity's financial health, the primary reserve ratio would not include any Property, Plant, and Equipment (PP&E) or Construction in Progress (CIP), and no amount of debt would be added back. When the composite score was first developed, institutions argued that they should not be penalized for investing in Property, Plant, and Equipment.
- The Department recognized that institutions may not have the records to associate debt obtained for long-term purposes with Property, Plant, and Equipment, and it developed a phased-in approach by developing two classes of debt obtained for long-term purposes – Pre-implementation Debt and Post-implementation Debt as well as Pre-implementation and Post-implementation PP&E and CIP. **Only Pre-implementation Qualified Debt and Post-implementation Qualified Debt up to the amount of Pre-implementation and Post-implementation PP&E and CIP will be considered for the primary reserve ratio.**

FINANCIAL RESPONSIBILITY UPDATE

Changes to the Treatment of Debt Obtained for Long-term Purposes

- The basis for the Pre-implementation PP&E and Qualified Debt will be the amounts reported in the institution's most recently accepted financial statement submitted to the Department prior to the effective date of the regulations. **An institution must adjust the amount of Pre-implementation Debt by any payments or other reductions and must also adjust the Pre-implementation PP&E by any depreciation/amortization or other reductions in subsequent years.**
- **Post-implementation Debt** is the amount of debt that an institution used to obtain PP&E since the end of the fiscal year of its most recently accepted financial statement submission to the Department prior to the effective date of the regulations less any payments or other reductions.
- An institution must clearly identify Pre- and Post-implementation Long-term Debt and PP&E net of depreciation or amortization and the amount of CIP and the related debt in a note to its financial statements for each debt to be considered for the composite score
- An institution must also disclose in a note to its financial statements, for each Pre- and Post-implementation Debt, the terms of its notes and lines of credit that include the beginning balance, actual payments and repayment schedules, ending balance, and any other changes in its debt including lines of credit.

FINANCIAL RESPONSIBILITY UPDATE

Changes to the Treatment of Debt Obtained for Long-term Purposes

- Pre-implementation Debt cannot increase, and the only amount of Pre-implementation Debt that can be included in the primary reserve ratio is the amount up to Pre-implementation PP&E.
- If an institution does not provide the required disclosures, no amount of debt will be included in the primary reserve ratio.
- The **Federal Register Final Rule** has significantly more detail on the reporting and accounting requirements for the treatment of debt obtained for long-term purposes than can be provided in this presentation. Institutions are encouraged to reference the Final Rule at this website:
https://ifap.ed.gov/sites/default/files/attachments/2019-09/FR092319_2.pdf
- The Department has also developed a **Financial Responsibility Questions and Answers**. That reference also provides a detailed example of how lines of credit should be treated for the purposes of whether they qualify as debt obtained for long-term purposes for the primary reserve ratio. Institutions are encouraged to reference that information at this website:
<https://ifap.ed.gov/electronic-announcements/040920FinancialResponsibilityQuestionsAnswers>

FINANCIAL RESPONSIBILITY UPDATE

Private Non-Profit Institutions – changes for ASU 2016-14

- Permanently Restricted Net Assets Change to: Net Assets with donor restrictions—restricted in perpetuity. If this amount is disclosed as a line item, part of a line item (in this case, it must also include a note disclosure of the actual amount), or note, or as a note in the financial statements, it is subtracted from total net assets for expendable net assets for the composite score calculation.
- Annuities, term endowments, and life income funds with donor restrictions are subtracted from total net assets. This amount must be disclosed as a line item, part of a line item (in his case, it must also include a note disclosure of the actual amount) or note, or as a note in the financial statements.

FINANCIAL RESPONSIBILITY UPDATE

Supplemental Schedule

- The Supplemental Schedule must be submitted as part of the required audited financial statements submission.
- The Supplemental Schedule must contain all of the financial elements required to compute the composite score.
- Each item in the Supplemental Schedule must have a reference to the Balance Sheet, Statement of Financial Statement, Statement of (Loss) Income, and Statement of Activities or Notes to the Financial Statements in order for the Department consider the information provided in determining whether to issue a final determination.
- The amount entered in the Supplemental Schedule should tie directly to a line item, be part of a line item (in this case, it must also include a note disclosure of the actual amount), or as a note in the financial statements.

FINANCIAL RESPONSIBILITY UPDATE

Private Non-Profit Institutions – Update to Ratio Terms (Appendix B)

- Expendable Net Assets = (net assets without donor restrictions) + (net assets with donor restrictions) – (net assets with donor restrictions: restricted in perpetuity) – (annuities, term endowments, and life income funds with donor restrictions) – (intangible assets) – (net property, plant, and equipment) + (post-employment and defined benefit pension plan liabilities) + (all long-term debt obtained for long-term purposes, not to exceed total net property, plant and equipment) – (unsecured related party receivables)
 - The value of Property, Plant, and Equipment updated to include the net amount of construction in progress and lease right-of-use assets
 - Post-employment liabilities updated to included defined benefit pension plan liabilities
 - Property, Plant and Equipment and Long-term debt details must be disclosed as previously discussed or long-term debt not allowed up to the amount of applicable value of Property, Plant, and Equipment

FINANCIAL RESPONSIBILITY UPDATE

Private Non-Profit Institutions – Update to Ratio Terms (Appendix B)

- Total Expenses Without Donor Restrictions and Losses Without Donor Restrictions = All expenses and losses without donor restrictions from the Statement of Activities
 - Less any losses without donor restrictions on investments, post-employment, and defined benefit pension plans and annuities
 - For institutions that have defined benefit pension and other post-employment plans, total expenses include the nonservice component of net periodic pension and other post-employment plan expenses, and these expenses will be classified as non-operating. Consequently, such expenses will be labeled non-operating or included with “other changes—nonoperating changes—in net assets without donor restrictions” when the Statement of Activities includes an operating measure.
- Modified Net Assets = (net assets without donor restrictions) + (net assets with donor restrictions) – (intangible assets) – (unsecured related party receivables)

FINANCIAL RESPONSIBILITY UPDATE

Private Non-Profit Institutions – Update to Ratio Terms (Appendix B)

- Modified Assets = (total assets) – (intangible assets) – (unsecured related party receivables)
- Change in net assets without donor restrictions is taken directly from the audited financial statements
- Total Revenue Without Donor Restriction and Gains Without Donor Restrictions = total revenue (including amounts released from restriction) plus total gains
 - With regard to gains, investment returns are reported as a net amount (interest, dividends, unrealized and realized gains and losses net of external and direct internal investment expense).
 - Institutions that separately report investment spending as operating revenue (e.g., spending from funds functioning as endowments) and remaining net investment return as a non-operating item will need to aggregate these two amounts to determine if there is a net investment gain or a net investment loss (net investment gains are included with total gains).

FINANCIAL RESPONSIBILITY UPDATE

Proprietary Institutions – Update to Ratio Terms (Appendix A)

- Adjusted Equity = (total owners' equity) – (intangible assets) – (unsecured related-party receivables) – (net property, plant and equipment) + (post-employment and defined benefit pension plan liabilities) + (all long-term debt obtained for long-term purposes, not to exceed total net property, plant and equipment)
 - The value of Property, Plant, and Equipment has been updated to include the net amount of construction in progress and lease right-of-use assets.
 - Post-employment liabilities have been updated to included defined benefit pension plan liabilities.
 - Property, Plant, and Equipment and long-term debt details must be disclosed as previously discussed, or long-term will not be allowed up to the amount of applicable Property, Plant, and Equipment.

FINANCIAL RESPONSIBILITY UPDATE

Proprietary Institutions – Update to Ratio Terms (Appendix A)

- Total Expenses and Losses excludes income tax; discontinued operations not classified as an operating expense; change in accounting principal; and any losses on investments, post-employment and defined benefit pension plans and annuities.
 - Any losses on investments would be the net loss for the investments.
 - Total Expenses and Losses includes the nonservice component of net periodic pension and other post-employment plan expenses.
- Modified Assets = (total assets) – (intangible assets) – (unsecured related-party receivables)
- Modified Equity = (total owner's equity) – (intangible assets) – (unsecured related-party receivables)

FINANCIAL RESPONSIBILITY UPDATE

Proprietary Institutions – Update to Ratio Terms (Appendix A)

- Income Before Taxes includes all revenues, gains, expenses, and losses incurred by the school during the accounting period.
 - Income before taxes does not include income taxes, discontinued operations not classified as an operating expense, or changes in accounting principal.
- Total Revenues and Gains does not include positive income tax amounts, discontinued operations not classified as an operating gain, or change in accounting principal.
 - Investment gains should be recorded net of investment losses.

FINANCIAL RESPONSIBILITY UPDATE

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