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Will Your Institution Pass the Financial-Responsibility Test?

BY KENT JOHN CHABOTAR

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

TAKEAWAYS

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

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

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

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

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 Among those concerns have been misinterpretations or miscalculations of the formulas, use of outdated accounting definitions and standards, and regional inconsistencies.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

What is the financial-responsibility test?

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

Some key facts about the test:

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

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

How is the test calculated?

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

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

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

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

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

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

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

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

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

What happens if an institution fails the test?

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

Table 1. Sample Ratio Methodology

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

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

What are concerns about the Education Department test?

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

- **The role of endowment losses in a bad economic environment.** Many financially sound colleges and universities had precipitous rating slides simply because an extraordinary market downturn depressed endowment values and total net assets in 2008 and 2009. How else do you explain Harvard University and Yale University at 2.2, Georgetown University at 1.6, and Leon's Beauty School in North Carolina at 3.0?
- **The limits that the financial-responsibility test places on the strength-factor scores of -1 to +3 may distort such results.** Those limits do not allow majestic strength or catastrophic weakness in one ratio to have its full effect on the other ratios. For example, in fiscal year 2009–10, Harvard's primary reserve strength-factor score was actually 54.3, but it was capped by the financial-responsibility test at 3.
- **Accounting standards.** Others question whether the test conforms to the latest accounting standards, is interpreted consistently by Department of Education financial analysts, and defines terms in conformity with the latest generally accepted accounting principles. For example, among the issues that NACUBO has cited with the financial-responsibility standards are:

  1. By adding unrealized investment losses to total expenses in the primary reserve ratio, the Education Department is double counting losses because both expenses and losses have already reduced unrestricted net assets.
  2. The department does not consider revolving lines of credit, state working-capital loan programs, and other debt as long term, even though the debt is not scheduled to be repaid within the next fiscal year and it has been classified as long-term debt on the audited financial statements.
  3. The department fails to include pension benefits as part of "postemployment and retirement benefits." The long-term portion of such obligations is added to the institution's spendable assets in calculating the ratios.
  4. The department will disallow pledges from board members unless trustees perform the role of trustee only and do not have other business relationships with the institution.
- **Other issues.** In addition, people have cited the misinterpretation of the test's purpose and results. Rather than identifying institutions in financial crisis on what is essentially a pass/fail basis, journalists and others have used the test results as a financial version of the *U.S. News & World Report* rankings. They have compared colleges and universities as if institution X with a score of 2.3 is more financially sound than institution Y with a score of 2. But rankings and other summary judgments about relative financial health should not be based on small differences, especially when many aspects of the financial-responsibility test are questionable.

Such uncertainties led the National Association of Independent Colleges and Universities (NAICU) to issue a statement following the publication of the fiscal year 2008–09 list in August 2010.

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

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

What should trustees and presidents do?

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

Some recommendations for dealing with the test are:

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

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

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

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

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

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

Questions for Trustees

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

AUTHOR: Kent John Chabotar is president of Guilford College and a faculty member at the Harvard Institutes for Higher Education.
E-MAIL: chabotar@guilford.edu
T'SHIP LINKS: Scott Schulick and Cynthia E. Anderson,"On Track for the Future: A Case Study in Strategic Finance." November/December 2010. Terry W. Hartle, "Coming Soon: Lots More Federal Regulations." November/December 2008.
OTHER RESOURCE: NACUBO Composite Financial Index Worksheet, http://www.nacubo.org/documents/business_topics/CFI_Other_Ratios_and_Trend_table.xls