authorized at the beginning of each official school board term, one member to act as President and another to act as Vice President. The President and Vice President shall each serve for 1 year. The President shall preside over school board meetings and provide leadership for related activities and functions. The Vice President shall serve in the absence of the President. If the position of President is vacated for any reason, the Vice President shall be the President until the next regularly scheduled school board election. The resulting vacancy in the position of the Vice President shall be filled by the majority vote of all members of the incumbent board.

(2) The DoD DDESS Arrangement Superintendent, or designee, shall serve as a non-voting observer to all school board meetings. The Installation Commander, or designee, shall convey command concerns to the school board and the Superintendent and keep the school board and the Superintendent informed of changes and other matters within the host installation that affect school expenditures or operations.

(3) School board members may not receive compensation for their service on the school board.

(4) Members of the school board may not have any financial interest in any company or organization doing business with the school system. Waivers to this restriction may be granted on a case-by-case basis by the Director, DoD DDESS, in coordination with the Office of General Counsel of the Department of Defense.

(b) *Electorate of the school board.* The electorate for each school board seat shall be composed of parents of the students attending the school. Each member of the electorate shall have one vote.

(c) *Election of school board members.* (1) To be elected as a member of the school board, an individual must be a resident of the military installation in which the DoD DDESS arrangement is located, or in the case of candidates for the Antilles Consolidated School System School Board, be the parent of an eligible child currently enrolled in the school system. Personnel employed by a DoD DDESS arrangement may not serve as school board members.

(2) The board shall determine the term of office for elected members, not to exceed 3 years, and the limit on the number of terms, if any. If the board fails to set these terms by the first day of the first full month of the school year, the terms will be set at 3 years, with a maximum of 2 consecutive terms.

(3) When there is a sufficient number of school board vacancies that result in not having a quorum, which is defined as a majority of seats authorized, a special election shall be called by the DoD DDESS Arrangement Superintendent or designee. A special election is an election that is held between the regularly scheduled annual school board election. The nomination and election procedures for a special election shall be the same as those of regularly scheduled school board elections. Individuals elected by special election shall serve until the next regularly scheduled school board election. Vacancies may occur due to the resignation, death, removal for cause, transfer, or disenrollment of a school board member's child(ren) from the DoD DDESS arrangement.

(4) The board shall determine a schedule for regular elections. Parents shall have adequate notice of the time and place of the election. The election shall be by secret ballot. All votes must be cast in person at the time and place of the election. The candidate(s) receiving the greatest number of votes shall be elected as school board member(s).

(5) Each candidate for school board membership must be nominated in writing by at least one member of the electorate to be represented by the candidate. Votes may be cast at the time of election for write-in candidates who have not filed a nomination petition if the write-in candidates otherwise are qualified to serve in the positions sought.

(6) The election process shall provide staggered terms for board members; e.g., on the last day of the last month of each year, the term for some board members will expire.

(7) The DoD DDESS Superintendent, in consultation with the school board, shall be responsible for developing the plans for nominating school board members and conducting the school board election and the special election process. The DoD DDESS Superintendent shall announce election results within 7 working days of the election.

Dated: November 22, 1996.

L.M. Bynum,

*Alternate OSD Federal Register Liaison Officer, Department of Defense.*

[FR Doc. 96–30383 Filed 11–27–96; 8:45 am]

BILLING CODE 5000–04–M

## DEPARTMENT OF EDUCATION

### 34 CFR Parts 600 and 668

RIN 1840–AC36

### Institutional Eligibility and Student Assistance General Provisions

**AGENCY:** Department of Education.

**ACTION:** Final regulations.

**SUMMARY:** The Secretary amends the Student Assistance General Provisions regulations by revising requirements for compliance audits and audited financial statements, revising the two-year performance exemption to the refund reserve requirement, and adding financial responsibility standards for foreign schools. 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.

The final regulations do not contain changes to the general standards of financial responsibility, which will be considered further by the Secretary.

**DATES:** *Effective date:* These regulations take effect July 1, 1997. However, affected parties do not have to comply with the information collection requirements in § 668.23 until the Department of Education publishes in the Federal Register the control number assigned by the Office of Management and Budget (OMB) to these information collection requirements. Publication of the control number notifies the public that OMB has approved these information collection requirements under the Paperwork Reduction Act of 1995.

**FOR FURTHER INFORMATION CONTACT:** Mr. David Lorenzo or Mr. John Kolotos, U.S. Department of Education, 600 Independence Avenue, S.W., Room 3045 ROB–3, Washington, D.C. 20202, telephone (202) 708–7888. Individuals who use a telecommunications device for the deaf (TDD) may call the Federal Information Relay Service (FIRS) at 1–800–877–8339 between 8 a.m. and 8 p.m., Eastern standard time, Monday through Friday.

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

Compliance audits and audited financial statements provide information necessary for the Secretary to determine whether an institution that participates or seeks to participate in the

title IV, HEA programs has the resources to deliver its education and training programs to students and the extent to which the institution complies with applicable statutory and regulatory requirements in its administration of the title IV, HEA programs.

On September 20, 1996, the Secretary published a notice of proposed rulemaking (NPRM) for this part in the Federal Register (61 FR 49552–49574 ). The NPRM included a discussion of the major issues surrounding the proposed changes (as well as a summary of the report by the firm of KPMG Peat Marwick, LLP) which will not be repeated here. The following list summarizes those issues and identifies the pages of the preamble to the NPRM on which a discussion of those issues may be found:

Revisions to the compliance audit requirements that would amalgamate the previous requirements for the provision of an audited financial statement; the proposed inclusion of a requirement for a proprietary institution to disclose the percentage of revenues it derives from title IV, HEA programs; audit submission requirements for foreign institutions; a clarification of the entity that must submit an audited financial statement; and a statement regarding the treatment of questionable accounting treatments contained in the required audited financial statement (pages 49555–49556).

The scope and purpose statement of the new Subpart L (page 49556).

The new ratio standards that comprise the main test of financial responsibility; a transition rule; and a proposed modification to an exception to the refund letter of credit requirement (pages 49556–49557).

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 (pages 49557–49558).

Financial responsibility standards and other requirements for institutions undergoing a change of ownership (page 49558).

Financial responsibility standards for foreign institutions (pages 49558–49559).

Past performance standards (page 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 (page 49559).

The contents of the proposed Appendix F (page 49559).

The following discussion describes significant changes since the publication of the NPRM.

General

In the September 20, 1996 NPRM, the Secretary indicated that the Department intended to publish final regulations by December 1, 1996, implementing new financial responsibility standards based on the proposed ratio methodology. However, in response to public comment on the proposed rules, the Secretary has decided to seek further comment and delay publishing final rules implementing these standards.

In particular, the public expressed concern that there was insufficient time for the Department to identify and address any possible problems with the proposed methodology and make needed technical adjustments. Commenters also asserted that institutions had insufficient time to review and provide meaningful comment on the methodology. Commenters from private non-profit institutions also expressed concern about the sufficiency of data on the effects of changed reporting standards that takes place when institutions begin reporting under Statement of Financial Accounting Standards 116 and 117 promulgated by the Financial Accounting Standards Board, and maintained that the Secretary should attempt to gather data on the effects of the changes and further evaluate the methodological adjustments made to the strength factors that are based on the estimated impact of that change. Finally, commenters urged the Secretary to consult with more members of the community regarding the potential impact of and possible improvements to the methodology.

The Secretary sought to implement the proposed rule effective July 1, 1997 to benefit institutions that do not satisfy the current financial responsibility standards, but could establish their financial responsibility under the proposed standards because those standards better evaluate the total financial condition of those institutions.

However, the Secretary is now convinced by commenters to await further analysis and consultation. The Secretary is, therefore, delaying publication of final regulations establishing a new subpart containing new financial responsibility standards and related regulations. The Secretary is publishing separately in the Federal Register a notice reopening the comment period for those parts of the September 20, 1996 NPRM not addressed in these Final Rules, and providing further information regarding the Secretary's plans.

Because the Secretary is delaying publication of final rules implementing the proposed changes to the financial responsibility standards, the Secretary is not creating a new Subpart L in these Final Rules, as was proposed in the September 20, 1996 NPRM. Nor is the Secretary removing the current § 668.15, as was also proposed in the September 20, 1996 NPRM. Instead, as discussed below, the Secretary is amending § 668.15 to add the revised refund reserve performance standard, to add the foreign schools financial responsibility standards, and to remove the additional submission of an audited financial statement. The Secretary is also amending § 668.23 to require the simultaneous submission of the audited financial statement and compliance audit, both performed on a fiscal year basis, and to require notification of 85/15 information as a note to the audited financial statement.

*Section 600.5—Proprietary Institution of Higher Education*

The Secretary is removing § 600.5(e), since the requirements for verifying 85/15 information will now be contained in § 668.23.

*Section 668.15—Factors of Financial Responsibility*

Because the Secretary is delaying publication of final regulations addressing factors of financial responsibility, § 668.15 is retained and amended to include the change in the two-year performance alternative to the refund reserve requirement, and to include financial responsibility standards for foreign schools. Both changes were originally proposed to be included in the new subpart L in the September 20, 1996 NPRM.

The Secretary is also removing § 668.15(e), since the audited financial statement will now be required to be submitted with the compliance audit under the requirements contained in § 668.23.

*Section 668.23—Compliance Audits and Audited Financial Statements*

The Secretary has made several technical changes to the language proposed in the September 20, 1996 NPRM. The Secretary is also removing the proposed section addressing the treatment of questionable accounting treatments.

As part of the consideration of the comments concerning the consolidated audit submissions, the Secretary has also restructured some of the regulation

language to simplify and clarify the requirements. Specifically, a new definition of Independent Auditor has been added to 668.23(a) to explain that the audits submitted under these regulations may be performed by certified public accountants or by government auditors that meet certain governmental standards. Similarly, a new section 668.23(e) has been created that consolidates language from several parts of the proposed regulation concerning access to auditor records for a school's or servicer's compliance or financial statement audit. This section also clarifies that such access includes the ability of the Secretary or Inspector General to make copies of such records.

The Secretary also received substantive comments on the provisions in § 668.23 that were formerly contained in § 668.24. While the Secretary, as described above, has made technical changes in these provisions, the Secretary does not address the commenters' substantive concerns here. The Secretary will consider those comments when final regulations addressing financial responsibility standards are published.

Analysis of Comments and Changes

In response to the Secretary's invitation in the September 20, 1996 NPRM, approximately 500 parties submitted comments on the proposed regulations. An analysis of the comments on § 668.15 and § 668.23 and of the changes in the regulations since publication of the NPRM is published as an appendix to these final regulations. In that appendix, the Secretary responds only to those comments pertaining to the final regulations published here. The Secretary will publish responses to all other comments when the Secretary publishes final regulations on the remainder of the regulatory areas addressed in the September 20, 1996 NPRM.

Major issues are grouped according to subject, with appropriate sections of the regulations referenced in parentheses. Other substantive issues are discussed under the section of the regulations to which they pertain. Technical and other minor changes—and suggested changes the Secretary is not legally authorized to make under the applicable statutory authority—are not addressed.

Executive Order 12866

*Assessment of Costs and Benefits*

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

The potential costs associated with the proposed regulations are those resulting from statutory requirements and those determined by the Secretary to be necessary for administering this program effectively and efficiently.

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

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

*Summary of Potential Costs and Benefits*

The Department has assessed the costs and benefits of the proposed regulations. This discussion is contained in the Regulatory Flexibility Analysis.

*Assessment of Educational Impact*

In the notice of proposed rulemaking, the Secretary requested comments on whether the proposed regulations would require transmission of information that is being gathered by or is available from any agency or authority of the United States.

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

Regulatory Flexibility Analysis

The Secretary has determined that small entities are likely to experience economic impacts from this regulation. Thus, the Regulatory Flexibility Act (RFA) requires that an Initial Regulatory Flexibility Analysis (IRFA) of the economic impacts be performed and that analysis, or a summary thereof, be published in the notice of proposed rulemaking. The IRFA was performed and a summary was published. This Final Regulatory Flexibility Analysis (FRFA) discusses the comments received on the IRFA and fulfills the other RFA requirements.

*Summary of Significant Issues Raised by the Public Comments on the Initial Regulatory Flexibility Analysis (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*

Changes were made in the final rule as a result of public comments. These changes are discussed elsewhere. Two commenters replied specifically to the IRFA. Their comments are summarized and discussed here.

*Comments:* Both commenters stated that the IRFA did not explore any alternatives.

*Response:* As stated in the IRFA, alternatives such as those that would establish differing compliance or reporting requirements or timetables based upon the size of the institution rather than the type of institution, or the use of performance standards rather than establishing baseline measures, or an exemption from coverage of the rule or any part thereof for small entities, would not adequately discharge the Secretary's obligation under section 498(c) of the HEA to determine the financial responsibility of institutions and guard the Federal fiscal interest. At the time the IRFA was completed, the Secretary determined that there were no significant alternatives that would satisfy the same legal and policy objectives while minimizing the economic impact on small entities. Public comment was received that the Secretary has determined requires additional consideration, so the comment period for several components of this regulation is being reopened. The Secretary welcomes comments that suggest additional alternatives consistent with the objectives of the Regulatory Flexibility Act.

*Changes:* The comment period for several components will be reopened to allow for additional public comment.

*Comments:* Both commenters stated that the IRFA did not consider economic impacts from regulatory provisions that are not addressed in these Final Rules. This includes opinions from one or both commenters that there may be impacts from: the change of ownership/additional location components; underestimation of the cost of obtaining a letter of credit; and, the notion that the cost of a letter of credit was not considered in the context of applications for new approvals or for changes in ownership.

*Response:* These comments will be discussed when the reopened comment period has closed for the ratio portions

of the final regulations and the final regulation is published.

*Changes:* The comment period for these components has been extended to allow for additional public comment.

*Comments:* One commenter raised numerous questions about the necessity for the rule itself.

*Response:* The preamble to the rule discusses the reasons why action by the Secretary is needed.

*Changes:* None.

*Comments:* One commenter stated that the IRFA did not consider the cost of changing the audit requirements. This commenter also asked questions about possible secondary effects of changing the audit requirements.

*Response:* The Secretary re-analyzed the component of this rule that requires changes in audit requirements. While there may be some slight costs associated with the transition to the new audit requirements, these costs are not thought to represent a significant economic impact.

*Changes:* The final regulatory flexibility analysis acknowledges the slight costs that may be associated with a transition to the new audit requirements.

*Description of the Reasons Why Action by the Department Is Being Considered and a Succinct Statement of the Objectives of, and Legal Basis for, the Proposed Rule*

The Secretary is directed by section 498(c) of the HEA to establish that institutions participating in title IV, HEA student financial assistance programs are financially responsible. The Secretary is directed by section 498(d) of the HEA to establish that institutions participating in the programs have the administrative capability to administer federal funds. As part of the regulatory reinvention process, the Secretary has analyzed the current standards whereby institutions can demonstrate financial responsibility and administrative capability and found that improvements can be made. The proposed improvements are discussed at length in the preamble to the September 20, 1996 NPRM.

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

The Secretary has adopted the U.S. Small Business Administration (SBA) Size Standards for this analysis. The Regulatory Flexibility Act directs that small entities are the sole focus of the Regulatory Flexibility Analysis. There are three types of small entities that are analyzed here. They are: for-profit entities with total annual revenue below $5,000,000; non-profit entities with total annual revenue below $5,000,000; and entities controlled by governmental entities with populations below 50,000. An estimate of the proportion of entities in each of these categories was calculated using the best available data from the National Center for Education Statistics IPEDS survey for academic year 1993–94. These estimates were applied to Department administrative files, where no data element for total revenue is available. The estimates are that 1,690 small for-profit entities, 660 small non-profit entities and 140 small governmental entities will be covered by the proposed rule. Where exact data were not available to estimate the proportion of small entities, data elements were chosen that would have overestimated, rather than underestimated, the proportion.

*Description of the Projected Reporting, Recordkeeping and Other Compliance Requirements of the Rule, Including an Estimate of the Classes of Small Entities Which Will Be Subject to the Requirement and the Type of Professional Skills Necessary for Preparation of the Report or Record*

The components of this final rule that may impose economic impacts are those associated with the new compliance audit requirements. The new audit requirements change the audit period from the award year to the institution's fiscal year. In some circumstances, this may entail a somewhat more involved audit if award rules change significantly from award year to award year so that the auditor would have to verify compliance with both the old and new sets of rules during the fiscal year. These changes are expected to cost $2,000 or less for a small entity with $5,000,000 in total revenue.

Changing the 85–15 compliance verification from the current attestation standard to a note to the financial statement is not expected to represent higher auditor fees. On balance, the amount of auditing work is comparable for both standards. Combining the audits is expected to reduce the economic cost of audits. While there may be some slight costs associated with the transition to the new audit requirements, these costs are not expected to represent a significant economic impact.

As discussed above, all small (and large) entities that are identified as being covered by the rule will be subject to the new audit requirements. The Regulatory Flexibility Act requires a discussion of the professional skills required for compliance with this rule. All small (and large) entities that participate in the title IV, HEA programs are required by statute to provide audits. These audits must be prepared by auditors that are qualified to prepare government audits. This rule changes the audit requirements, but does not impose a significantly new activity upon the entities. Under the current regulations, an institution must submit an audited financial statement and a compliance audit, but the financial statement was submitted twice. Under these new regulations, the institution will still be required to submit both the audited financial statement and the compliance audit, but the financial statement will only be submitted once, at the same time as the compliance audit is submitted. Thus the savings to institutions is the marginal savings that is produced by the elimination of the extra submission of the audited financial statement.

*Description of the Steps the Department Has Taken To Minimize the Significant Economic Impact on Small Entities Consistent With the Stated Objectives of Applicable Statutes*

This rule reduces the number of audits which must be submitted to the Secretary, removing a reporting requirement that overlaps with this proposed rule. This should help to reduce the overall reporting costs to participating institutions.

*A Statement of the Factual, Policy, and Legal Reasons for Selecting the Alternative Adopted in the Final Rule and Why Each One of the Other Significant Alternatives to the Rule Considered by the Department That Affect the Impact on Small Entities Was Rejected*

For the purpose of this regulatory flexibility analysis, the significant alternative that was considered by the Secretary and rejected was that of "no action." Other alternatives, would not adequately discharge the Secretary's obligation under sections 498 (c) and (d) of the HEA to determine the financial responsibility and administrative capability of participating institutions and guard the Federal fiscal interest.

The Secretary has determined that there are no other significant alternatives that would satisfy the same legal and policy objectives while minimizing the economic impact on small entities. This determination is based, in part, on the extensive consultation that the Department performed with small (and large) entities in developing these proposed revisions. The alternative "no action" was rejected because this alternative would not adequately protect the

Federal fiscal interest, as discussed above and in the appendix to the final rule.

Conclusion

The Secretary concludes that a substantial number of small entities are likely to experience significant adverse economic impacts from the proposed rule. However, the Secretary has concluded that the costs are outweighed by the benefits. In this case, the benefits are better protection of the Federal fiscal interest as well as improved service to students receiving assistance under the title IV, HEA programs.

The Secretary emphasizes that this conclusion addresses the regulations published in this Final Rule. Additional analysis of, and conclusions regarding, the other regulatory proposals that were part of the September 20, 1996 NPRM will be published when final regulations addressing those proposals are published, and will be based on comments received during the initial comment period, and those received during the reopened comment period.

Paperwork Reduction Act of 1995

The information collection requirements contained in § 668.23 have been submitted to the Office of Management and Budget for approval.

List of Subjects

*34 CFR Part 600*

Colleges and universities, Foreign relations, Grant programs—education, Loan Programs—education, Reporting and recordkeeping requirements, Student aid, Vocational education.

*34 CFR Part 668*

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

(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, State Student Incentive Grant Program, and 84.268, Direct Loan Program)

Dated: November 22, 1996.

Richard W. Riley,

*Secretary of Education.*

The Secretary amends parts 600 and 668 of title 34 of the Code of Federal Regulations as follows:

## PART 600—INSTITUTIONAL ELIGIBILITY UNDER THE HIGHER EDUCATION ACT OF 1965, AS AMENDED

1. The authority citation for part 600 continues to read as follows:

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

### § 600.5 [Amended]

2. Under § 600.5, paragraph (e) is removed and reserved.

## PART 668—STUDENT ASSISTANCE GENERAL PROVISIONS

3. 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.

4. Under § 668.15, paragraph (e) is removed and reserved, paragraph (g) is revised, and paragraph (h) is added to read as follows:

### § 668.15 Factors of financial responsibility

* * * * *

(g) *Two-year performance requirement.* (1) The Secretary considers an institution to have satisfied the requirements in paragraph (d)(1)(C) of this section if the independent certified public accountant, or government auditor 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—

(i)(A) For either of those fiscal years, did not find in the sample of student records audited or reviewed that 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

(B) The Secretary considers the institution to have satisfied the conditions in paragraph (g)(1)(i)(A) of this section if the auditor or reviewer finds in the sample of student records audited or reviewed that the institution made only one late refund to a student in that sample; and

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

(2) If the Secretary or a State or guaranty agency finds during a review conducted of the institution that the institution no longer qualifies for an exemption under paragraph (d)(1)(C) of this section, the institution must—

(i) Submit to the Secretary the irrevocable letter of credit required in paragraph (b)(5) of this section no later than 30 days after the Secretary or State or guaranty agency notifies the institution of that finding; and

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

(3) If the auditor who conducted the institution's compliance audit finds that the institution no longer qualifies for an exemption under paragraph (d)(1)(C) of this section, the institution must submit to the Secretary the irrevocable letter of credit required in paragraph (b)(5) of this section no later than 30 days after the date the institution's compliance audit must be submitted to the Secretary.

(h) *Foreign institutions.* The Secretary makes a determination of financial responsibility for a foreign institution on the basis of financial statements submitted under the following requirements—

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

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

* * * * *

5. Section 668.23 is revised to read as follows:

### § 668.23 Compliance audits and audited financial statements.

(a) *General.* (1) *Independent auditor.* For purposes of this section, the term ''independent auditor'' refers to an independent certified public accountant or a government auditor. To conduct an audit under this section, a government auditor must meet the Government Auditing Standards qualification and independence standards, including

standards related to organizational independence.

(2) *Institutions.* An institution that participates in any title IV, HEA program must at least annually have an independent auditor conduct a compliance audit of its administration of that program and an audit of the institution's general purpose financial statements.

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

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

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

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

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

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

(ii) Procedures for audits contained in audit guides developed by, and available from, the Department of Education's Office of Inspector General.

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

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

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

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

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

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

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

(d) *Audited financial statements.* (1) *General.* To enable the Secretary to make a determination of financial responsibility, an institution must, to the extent requested by the Secretary, submit to the Secretary a set of financial statements for its latest complete fiscal year, as well as any other documentation the Secretary deems necessary to make that determination. Financial statements submitted to the Secretary must be prepared on an accrual basis in accordance with generally accepted accounting principles, and audited by an independent auditor in accordance with generally accepted government auditing standards, and other guidance contained in the Office of Management and Budget Circular A–133, ''Audits of Institutions of Higher Education and Other Nonprofit Organizations''; Office of Management and Budget Circular A–128, ''Audits of State and Local Governments''; or in audit guides developed by, and available from, the Department of Education's Office of Inspector General , whichever is applicable. As part of these financial statements, the institution must include a detailed description of related entities based on the definition of a related entity as set forth in the Statement of Financial Accounting Standards (SFAS) 57. The disclosure requirements under this provision extend beyond those of SFAS 57 to include all related parties and a level of detail that would enable to Secretary to readily identify the related party. Such information may include, but is not limited to, the name, location and a description of the related entity including the nature and amount of any transactions between the related party and the institution, financial or otherwise, regardless of when they occurred.

(2) *Submission of additional financial statements.* To the extent requested by the Secretary in determining whether an institution is financially responsible, the Secretary may also require the submission of audited consolidated financial statements, audited full consolidating financial statements, audited combined financial statements or the audited financial statements of one or more related parties that have the ability, either individually or collectively, to significantly influence or control the institution, as determined by the Secretary.

(3) *Audited financial statements for foreign institutions.* A foreign institution must submit—

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

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

(4) *Disclosure of title IV HEA program revenue.* A proprietary institution must disclose in a footnote to its financial statement audit the percentage of its revenues derived from the title IV, HEA program funds that the institution received during the fiscal year covered by that audit. The revenue percentage must be calculated in accordance with § 600.5(d).

(5) *Audited financial statements for third-party servicers.* A third-party servicer that enters into a contract with a lender or guaranty agency to administer any aspect of the lender's or guaranty agency's programs, as provided under 34 CFR part 682, must submit annually an audited financial statement. This financial statement must be prepared on an accrual basis in accordance with generally accepted accounting principles, and audited by an independent auditor in accordance with generally accepted government auditing standards and other guidance contained in audit guides issued by the Department of Education's Office of Inspector General.

(e) *Access to records.* (1) An institution or a third-party servicer that has a compliance or financial statement audit conducted under this section must—

(i) Give the Secretary and the Inspector General access to records or other documents necessary to review that audit, including the right to obtain copies of those records or documents; and

(ii) Require an individual or firm conducting the audit to give the Secretary and the Inspector General access to records, audit work papers, or other documents necessary to review that audit, including the right to obtain copies of those records, work papers, or documents.

(2) An institution must give the Secretary and the Inspector General access to records or other documents necessary to review a third-party servicer's compliance or financial statement audit, including the right to obtain copies of those records or documents.

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

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

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

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

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

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

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

(ii) The Secretary permits a longer repayment period.

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

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

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

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

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

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

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

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

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

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

## Analysis of Comments and Changes

(Note: This appendix will not be codified in the Code of Federal Regulations)

### *General*

*Comments:* Many commenters maintained that the 45 day comment period was too short for institutions to understand thoroughly the new proposals and submit comments on them. Many commenters also maintained that the turnaround time between November 4 (the end of the comment period) and December 1 (the deadline for publication of final regulations in time for implementation for the 1997–1998 award year in accordance with the Master Calendar) was too short for Department staff to understand the comments that were submitted and to make necessary changes in the regulations based on those comments. These commenters therefore recommended that the publication of final rules be delayed, and the comment period extended.

*Discussion:* The Secretary has reviewed these comments and is sympathetic to some of the concerns raised that additional time would have been desirable for the public to consider some of the proposals in more detail. The September 20, 1996 Notice of Proposed Rulemaking provided a detailed discussion of the competing concerns at issue given the statutory deadline that requires final rules to be published by December 1 in order to go into effect by July 1 of the following year. The Secretary also notes that many members of the public were able to use the allotted time to study the proposed regulation and provide detailed comments with constructive suggestions for improving the final regulation. These

comments also identified areas where the proposed regulation may need further study and review, particularly with respect to some of the components of the financial responsibility ratios calculated under the proposed methodology.

Based in large part on concerns identified in the comments, the Secretary is withholding publication of final regulations implementing the revised financial responsibility standards at this time, and details concerning time frames for additional public comment on that proposal will be set out in a separate Federal Register Notice. The portions of the September 20 NPRM that are now being incorporated into Final Regulations are discussed in detail in the following sections.

*Changes:* Certain portions of the proposed regulations that are dependent upon the financial responsibility ratio calculations are being held back for additional consideration, and the final regulations on the remaining portions of the September 20 NPRM are set out and discussed below.

*Comments:* Several commenters maintained that the current standards of financial responsibility could not be changed unless the Department engaged in the process of negotiated rulemaking, as specified in section 492 of the HEA, or that at least the spirit of that section required that the Department enter into further discussions with the community on these matters. One commenter alleged that without negotiated rulemaking, the Department could not promulgate regulations on this subject that would have legal force and effect.

*Discussion:* Pursuant to Section 492 of the HEA, the Secretary conducted negotiated rulemaking for the regulations that implemented parts B, G and H of the HEA as amended by the Higher Education Amendments of 1992. The promulgation of those regulations, and the procedures specified for those regulations—regional meetings, followed by negotiated rulemaking—were subject to a specific time limit set out in the statute, tied to the enactment of the 1992 Amendments. The requirement to conduct regional meetings and negotiated rulemaking for regulations implementing those parts thus did not extend to subsequent changes to those regulations. No corresponding time limits or procedures were provided in the HEA for any regulations other than the ones that were initially required due to the 1992 amendments. The Secretary, therefore, disagrees with the suggestions from the commenters that negotiated rulemaking would have been required as part of the implementation of these regulations.

*Changes:* None.

*Section 668.15: Factors of Financial Responsibility*

*Comments:* Many commenters supported the proposed change to the performance exception to the refund reserve requirement. These commenters also requested that the Department take prompt action to approve applications regarding several state tuition recovery funds that are still pending. Several of these commenters also suggested that the exceptions be expanded to exempt an institution that obtains a performance bond as required by a state licensing agency. This commenter maintained that such bonds typically provide for refunds to students in cases of school closure.

Several commenters supported the proposed change, but maintained that a 10 percent or 15 percent error threshold would be fairer and more appropriate, especially for institutions with very few refunds, since in those cases even one or two late refunds may exceed the 5 percent threshold. One of these commenters added that this would take into account those refunds paid a day or two late due to payments on a 30-day cycle. Several commenters noted that a threshold based on the number of refunds made late, with no consideration of the amount of money that was late in being refunded, was inadequate, because a few refunds might be substantial due to the amount of money involved, or, conversely, appreciably more refunds than a 5 percent measure could be immaterial due to the inconsequential amount of money involve. One commenter suggested that a monetary threshold be included in the performance requirement, such that the standard be that the institution did not make the greater of 5 percent or $5000 of refunds late. One commenter suggested that for institutions that make a small number of refunds every year, such that one late refund would cause the institution to exceed the 5 percent threshold, the Department take several years of refund history into account, and, if no pattern of late refunds emerges, determine that the institution meets the performance standard.

A commenter representing an accounting firm believed that an institution that satisfied the general financial standards should not be subject to the refund reserve provisions.

One commenter requested clarification regarding whether the 5 percent late refund trigger for the refund reserve requirement would be counted at each site for an institution that has additional locations, or whether the standard would be applied to the institution as a whole, including the additional sites with the main campus.

Several commenters asked that the refund reserve performance exception be clarified to include the results of an appeal process for findings regarding late refunds.

Several commenters requested clarifications of the revised refund reserve fund performance standard with regard to the standard being linked to the years covered by an auditor or the year during which the auditor conducts the audit. One of these commenters asked whether a late refund that is split among several programs is counted as one late refund or several late refunds. This commenter maintained that the former should be the case.

A commenter from a proprietary institution asked whether the 5 percent error rate would be based on the refunds examined or an extrapolation of the refunds examined. This commenter maintained that an extrapolated 5 percent error rate is not indicative of an institution that is not financially responsible, nor indicative of a reportable condition related to the payment of refunds.

Several commenters suggested that only FFEL and Direct Loan Program refunds be counted as untimely in the refund percentage because only late refunds to those programs will have financial consequences to the Federal government or the student.

*Discussion:* The Secretary appreciates the support this proposal generally received from the community. The Secretary, however, is not convinced by arguments that the original proposal should be changed substantively.

In particular, the Secretary believes that the only accurate way to determine whether an institution is making its refunds under the standards contained in § 668.22 is by setting a measure of refunds made or not made in a timely fashion. The Secretary does not agree with those commenters who believe that a dollar amount should be part of the threshold, such that an institution would be allowed to qualify under this exemption if the institution makes more than 5 percent of its refunds late, but the dollar amount of those refunds is low. This performance exemption is premised on providing relief to an institution that has created and maintained an efficient system that allows the institution to discharge the responsibilities it assumes by participating in a title IV, HEA program. In this case, the performance of the system must be measured on the basis

of making refunds. The Secretary does not believe that adding a dollar threshold to the 5 percent error threshold would create a better measure than the 5 percent threshold alone, since the dollar threshold will not yield additional information on how well the system is processing refunds. In fact, such a threshold would allow an institution to continue using the exemption even though its system performed with a significant error rate, so long as the dollar amount of each refund made late was low.

While the Secretary appreciates the position taken by commenters who argued the obverse (that an institution that made a few but very large refunds late should not qualify for this exemption), the Secretary believes that the more appropriate enforcement action in cases where an institution inadvertently made a few refunds of large amounts late should be taken under the standards set in § 668.22. Those standards address the act of making a refund rather than the process that controls the making of refunds, and are therefore better suited to generate appropriate sanctions, if any, in response to deficiencies in the making of a particular refund or refunds.

The Secretary also disagrees with those commenters who maintained that the Secretary should set the error rate at a higher threshold. The 5 percent threshold was meant to provide relief only in those rare instances when, although the institution's system of internal controls is generally sound, a few refunds are inadvertently made late. The Secretary does not agree that a 10 or 15 percent error threshold would capture the intent of the exemption as a performance standard that indicates that the institution does, in all but rare situations, make refunds in a timely fashion. Rather, the Secretary believes that a 10 or 15 percent error rate may indicate that serious problems exist with the institution's system of internal controls, as well as significant compliance problems.

The Secretary agrees with commenters who asserted that a single late refund should not trigger the refund reserve requirement if, due to the small number of refunds the institution makes annually, a single refund would constitute more than 5 percent of the institution's annual refunds. While the Secretary expects institutions that have small numbers of refunds to be equally responsible as institutions with large numbers of refunds in ensuring that all refunds are paid in a timely fashion, the Secretary believes that it is reasonable to allow an institution to continue utilizing this exemption if it is found to have made only one refund late during its fiscal year, even though that single refund represented 5 percent or more of the refunds the institution was required to make during that year.

In promulgating this revision to this exemption, the Secretary emphasizes that the 5 percent threshold does not give an institution license willfully to make some number of late refunds so long as the percentage of late refunds is less than 5 percent. The 5 percent threshold is meant to allow institutions to qualify under this exemption if the instances in which the institution does not meet the regulatory requirements for the payment of all its refunds are rare and exceptional. The 5 percent threshold thus allows such institutions to qualify for the exemption despite those rare and exceptional instances of late payment. But, the Secretary reminds institutions that attempts to abuse this exemption by willfully making a percentage of late refunds could result in actions taken under § 668.22. In addition, the institution's independent auditor is required to make a finding of a material weakness in the institution's procedures related to refunds if the auditor finds that the institution intentionally or systematically made late refunds, and such a finding would result in the institution losing the benefit of this exemption.

The Secretary disagrees with those commenters who asserted that only those refunds that contain FFELP or Direct Loan funds should be counted as untimely. Refunds made to grant programs must also be made in a timely fashion, not only for Federal fiscal reasons, but also because those funds may be subsequently used as aid to other needy students and should be available to those students as soon as possible. Thus, the Secretary includes refunds that do not contain FFELP or Direct Loan funds in the measure of refund performance for purposes of this exemption.

In response to other concerns raised by commenters, the Secretary wishes to clarify the following. The 5 percent threshold applies to the number of refunds made late, not to the number of programs to which funds are remitted. Late refunds will be evaluated on the combination of a main campus and any additional locations. Evaluations are also made for the period of time covered by the auditors or reviewers.

The Secretary also wishes to clarify that the procedures that occur when the letter of credit requirement is triggered are the same as current procedures. If the auditor or reviewer finds, in his or her examination of a sample of student records, that 5 percent or more of the refunds that should have been made to those students in the sample were made late, then the institution must immediately submit a letter of credit. That letter of credit then remains in place until the final report of the reviewer or auditor shows that the institution made fewer than 5 percent of its total required refunds late, or until the institution can meet the two-year performance exemption based on subsequent reviews or audits, or meets one of the other alternatives.

The Secretary, based on past experience with performance bonds, disagrees that they are an acceptable way of meeting the refund reserve requirement. The Secretary has found that the terms of coverage and conditions for collection on performance bonds are difficult to administer consistently, and do not provide the same level of protection available under letters of credit.

The Secretary is currently reviewing several applications regarding state tuition recovery funds. Such applications have not conformed to the regulatory provisions contained in 668.15(d)(2)(ii). The Secretary agrees that such funds are a good way for institutions to meet the refund reserve requirements and looks forward to receiving applications detailing such state plans that would conform to the regulatory provisions.

*Changes:* Because the Secretary is delaying the publication of the final rules implementing the new proposed standards of financial responsibility, § 668.15 is being amended to include this change to the two-year performance requirement. Language allowing an institution to use this exemption if the auditor or reviewer found that the institution made only one late refund has also been added, and technical changes to regulatory language have been made to make the exemption easier to understand.

*Comments:* One commenter agreed that the proposed standards for foreign institutions were appropriate.

*Discussion:* The Secretary appreciates this support of the proposal. The Secretary believes these standards appropriately set levels of oversight for foreign institutions given the level of risk represented respectively by institutions that receive $500,000 or less annually in title IV, HEA program funds, and those that receive more than $500,000 annually in such funds.

*Changes:* None.

*Section 668.23 Compliance Audits and Audited Financial Statements*

*Comments:* A commenter from a public institution maintained that, because of cost, a compliance audit should be required only once every two or three years for a public institution, instead of annually. A commenter from a public institution maintained that the Single Audit Act does not require that the audited financial statements of individual public institutions be submitted. One commenter requested clarification of the type of audit required of an institution that falls below the level of the OMB Circular A–133 audit requirement of $300,000.

Several commenters from accounting firms supported the requirement that audited financial statements be included in the compliance audit and that the compliance audit be prepared on a fiscal year basis, on the grounds that this would result in cost reductions to institutions without compromising the ability of the Department to perform its oversight responsibilities.

Many commenters from proprietary institutions and the certified public accountant (CPA) community opposed the new requirement. These commenters asserted that for those institutions that have a fiscal year different from an award year, the change would result in compliance audits that cover two different award years, sometimes involving a single student's file that would have to be examined under two different standards, and that this would add significant costs and burdens to institutions. In particular, some commenters also asserted that this change would result in audits being prepared during the busy season for CPAs, thereby increasing costs; that it might entail using a single auditor rather than two different auditors, which would also lead to increased costs; and, if the initial audit after the change would require the audit of a partial year, this would also increase costs. Commenters who opposed changing the reporting year for compliance audits from an award year basis to a fiscal year basis estimated that time and costs would increase in a range of 40 percent to 100 percent.

A commenter from a proprietary institution opposed the requirement that compliance audits be performed on a fiscal year basis, on the grounds that information contained on the PMS 272 Report will not match information on the final report of expenditures—the Federal Pell Grant Statement of Account and the Fiscal Operations Report and Application to Participate (FISAP) for campus-based programs. This commenter also argued that there will be no mechanism in place for the institution to receive an increased authorization to cover additional Pell Grant eligibility, since adjustments to award year authorizations must be done in the initial audit report.

One commenter from a Subchapter S corporation asserted that the combination of the compliance audit and the audited financial statement would not result in more time for an institution to complete its audit, because other government agencies require the corporation to provide audited financial statements within 120 days of the end of the institution's fiscal year. This commenter maintained that creating a combined audit requirement meant that the corporation would be required to complete both the audited financial statement and the compliance audit in that timeframe. This commenter maintained that, therefore, this requirement was impossible to meet, because a compliance audit typically takes more than five months to complete. This commenter also maintained that the combined audit would create problems for a corporation with several separate schools when the corporation submits an audited financial report to other entities (such as those involved in bonding, insurance, and banking), because the combination would consist of the financial statement and several different compliance audits that are unrelated to the institution for which the report was requested. This commenter maintained that the proposed rule does not reduce any burden other than that of a separate mailings, since the current requirements do not require duplicate information. A commenter from a proprietary institution argued that the combined audit would be burdensome to some publicly traded corporations because those companies are required to prepare an audited financial statement with the Security and Exchange Commission within three months of the institution's fiscal year end, and this would also be the time period in which the institution would be required to complete a compliance audit. One commenter recommended either that the Department negotiate with the Internal Revenue Service to allow S corporations to change their fiscal year from January 1 to December 31, or to change the award year to the calendar year.

Many commenters suggested as an alternative that an institution might either combine its audited financial statement with its compliance audit, with both covering the same period of time, or allow the institution to submit a single audit, with the financial statement and compliance audit covering different periods of time (the financial statement covering the institution's most recently completed fiscal year, and the compliance audit covering the award year). One commenter asserted that the combination is not necessary as long as the firm conducting the audit of the financial statements is subjected to the current Quality Review, and the compliance auditor and the financial statement auditor can consult with one another.

One commenter representing a guarantee agency opposed the combined audit on the grounds that the change in the submission deadline from four months to six months increased risk to students and taxpayers.

Several commenters asked for clarification if two separate auditors could perform the compliance audit and audit the institution's financial statement.

Several commenters requested more information regarding the time period to be covered by the first combined submission and the due date for the first combined submission. One of these commenters asked whether a compliance audit of less or more than 12 months would be acceptable during the transition.

A commenter from an accounting firm commented that the requirement that the audit be prepared according to Generally Accepted Government Auditing Standards (GAGAS) would mean higher costs for institutions. One commenter maintained that only public institutions should be required to use GAGAS, and all other institutions be allowed to use Generally Accepted Auditing Standards (GAAS).

*Discussion:* It was not the Secretary's intent to preclude the preparation of financial statement audits and compliance audits as separate reports. The Secretary will accept a financial statement audit and a compliance audit performed by different auditors provided that both audits are conducted on a fiscal year basis and are submitted together as one package. The Secretary is aware that for many institutions the award year differs from the fiscal year and that this may require that auditors perform audit testing in each of two distinct award years, both of which may be subject to different regulatory requirements. The Secretary believes that although this may require additional planning with respect to developing samples for substantive tests of details, the level and complexity of any additional work is not substantially greater than would normally be required. Auditors would still perform

reconciliation work and tests of balances relative to the award year but would now be required to supplement that work, at fiscal year end, with additional reconciliation work and tests of balances. However, the nature and extent of those tests and the amount of work associated with these activities would be minimal unless year-end testing of internal controls indicated a significant change in the reliability of the internal control structure. This may result in a modest increase in the level of work auditors must perform during peak demand periods, and consequently may result in slightly higher audit fees, depending on the auditor. Historically, auditors have been required to adapt their procedures to accommodate statutory and regulatory changes that have occurred at varying periods throughout individual award years. The Secretary believes that the benefits associated with consolidating multiple regulatory reporting requirements into a single reporting package exceed the incremental costs incurred. In addition, auditors who perform audits and attest services for participating institutions have a responsibility to be aware of changing statutory or regulatory requirements, and to develop appropriate plans for accommodating changes in those requirements.

An initial compliance audit covering a partial year will be required at the institution's first fiscal year end following the effective date of the regulations, and will cover the period of time since the institution's last compliance audit. For an institution with a fiscal year end of December 31st, an initial compliance audit will be required for the period beginning July 1, 1997 and ending December 31, 1997. In subsequent years, the compliance audit will be prepared on a fiscal year basis and will cover the period of time since the institution's last compliance audit. For an institution with a December 31st fiscal year end, the next required compliance audit and financial audit would be required to be submitted together in a single package for the fiscal year ending December 31st, 1998 not later than six months following the institution's fiscal year end. Although some commenters have suggested that the Secretary allow institutions to prepare an initial compliance audit at the end of the institution's second fiscal year following the effective date, the Secretary believes this creates an unacceptable delay with regard to his receiving notification of potentially serious compliance violations. Accordingly, the Secretary is requiring institutions to prepare a partial year compliance audit at the end of the first fiscal year following the effective date of the regulation.

For many institutions with a December 31st fiscal year end, this change will provide the Secretary with more timely information with respect to compliance audits. Under previous regulations a compliance audit for an award year ending June 30th would not have been required to be received by the Secretary until six months following a December 31st fiscal year end. By changing the requirement that a compliance audit be prepared on an award year basis to that of a fiscal year, the Secretary shortens the period in which a compliance audit is received to six months instead of nearly a year. This may also provide the Secretary with a means of ascertaining the potential impact of serious audit liabilities with respect to an institution's ability to demonstrate financial responsibility. The Secretary further believes that the consistency in reporting periods will encourage independent CPAs who perform financial statement audits to identify and properly disclose any material contingent liabilities that exist as a result of compliance violations.

In contrast, this change extends the period of time in which institutions may submit financial audits from four months under previous regulations to six months. This change should prove beneficial to institutions. In addition, the Secretary believes that a change in the reporting period from the award year to the fiscal year provides institutions with an opportunity to consolidate audit services into a single engagement rather than to incur the potentially higher costs associated with separate engagements .

The required audit submission is considered to be satisfied by an audit under the Single Audit Act and OMB Circular A–128 or OMB Circular A–133. However, for institutions that are not required to prepare such audits because the total amount of federal financial assistance is less than the applicable threshold amount, a financial audit report and a compliance audit must be prepared and submitted to the Secretary for purposes of complying with the HEA. Guidance in the preparation of the compliance audit may be sought from the U.S. Department of Education's Office of the Inspector General.

With regard to the issue of fiscal years for S corporations, the Secretary has promulgated a regulation that permits schools to synchronize their compliance audit to correspond with their fiscal year. The Secretary therefore does not believe it is necessary for an institution to be able to switch its fiscal year to correspond to the award year, but has rather provided a means for an institution to change the period covered by its annual compliance audit so that it will correspond to its fiscal year.

Existing law requires the Inspector General to take appropriate steps to assure that any work performed by non-federal auditors complies with Generally Accepted Government Auditing Standards (GAGAS). This provision reflects a clarification of existing guidance previously made available to auditors in publications available from the Department of Education's Office of the Inspector General .

*Changes:* Several technical changes have been made to § 668.23.

*Comments:* Several commenters representing proprietary institutions supported the concept of the submission of questionable audit statements to the American Institute of Certified Public Accountants (AICPA) and other parties for review as part of a fair and impartial way of settling disputes between auditors and the Department, but questioned the language contained in this proposed rule. One of these commenters questioned whether the AICPA would agree to serve in this capacity, and asserted that the reference to other parties in the proposed rule was unclear. One commenter asserted that the AICPA does not have a process for resolving accounting disputes between parties, but does have a process, through the Professional Ethics Executive Committee, by which parties may be referred for investigation and disciplinary action if there is a possible violation of professional standards, and a process, through the Accounting Standards Executive Committee, for considering whether there is a need for new accounting standards.

Some commenters suggested that it was very important that the ''other parties'' be familiar with the intricacies of the particular sector of higher education involved in the question or dispute, and that it was also very important that the Secretary create a process for providing notice and soliciting comment from experts in the particular sector associated with the question or dispute when the Secretary submits a statement for resolution.

One of these commenters maintained that the proposed procedures could be problematic because there are several different legitimate ways to reflect similar transactions.

*Discussion:* In exercising the Department's statutory oversight authority, the Secretary makes every effort to ensure that the regulatory standards are applied consistently

among all participating institutions. One way that the Secretary ensures that regulatory provisions are consistently applied is to evaluate the accounting principles used in the preparation of financial statements. Different representations of similar financial circumstances by preparers of those financial statements may lead the Secretary to form fundamentally different conclusions about the fiscal responsibility of the respective institutions. The Secretary looks to the auditor first as a way of ensuring consistent application of accounting principles among reporting institutions.

In proposing the mechanism described in the proposed § 668.23 (d)(2), the Secretary had intended to establish a formal procedure to resolve significant discrepancies that may exist among independent auditors in the interpretation of Generally Accepted Accounting Principles (GAAP). Notwithstanding this procedure, the Secretary, as the principal user of these financial statements, would remain the ultimate authority in determining the acceptability of any general purpose financial statement for purposes of demonstrating financial responsibility. However, several commenters had indicated that the procedure proposed in the NPRM was not workable from the standpoint of the AICPA, in that the AICPA generally took action to clarify accounting principles in the long term rather than to help adjudicate particular differences. After reviewing the concerns raised by the commenters, the Secretary agrees that the type of assistance the Department could procure from the AICPA would not necessitate the procedure proposed in the NPRM. The Secretary is, therefore, removing this proposal from the final regulations.

The Secretary, however, reiterates that the Department will generally consult with authoritative accounting bodies such as the Financial Accounting Standards Board (FASB), The Governmental Accounting Standards Board (GASB), and the AICPA when examining audited financial statements. If, after consideration of the facts, circumstances, and assumptions, the Secretary believes that a departure from GAAP exists, the Secretary will notify the institution of the finding and may provide the institution with an opportunity to cure. In the event the Secretary believes that existing accounting standards need to be changed or that existing accounting standards are silent and that more guidance is needed, the Secretary will bring the matter to the attention of the appropriate accounting standard-setting body or bodies for consideration of future changes. However, the Secretary will continue to be the final authority in determining the acceptability of any specific accounting treatment for purposes of determining the financial responsibility of an institution that participates in a title IV, HEA program.

*Changes:* The provision contained in the proposed § 668.23(d)(2) has been removed.

*Comments:* Many commenters representing proprietary institutions opposed the provision that enables the Secretary to require the submission of audited financial statements of related entities, consolidated financial statements, or full consolidating financial statements, on the grounds of excessive cost and burden. Several of these commenters maintained that all necessary information is contained in the footnotes to the audited financial statements submitted by institutions. One of these commenters maintained that this provision would be acceptable only if the requirement was limited to those instances in which the Internal Revenue Service requires consolidation. Several commenters representing proprietary institutions maintained that the provision was unacceptable and should be removed. One commenter suggested that the rule read that, if the parent corporation is willing to provide a guarantee of the financial obligation of the institution, then the financial statements of the parent corporation will be considered.

One commenter argued that a particular definition of ''related'' must be promulgated, and that this definition should be constructed so as to exclude any entity that does not have a direct and significant financial relationship with the institution.

One commenter representing proprietary institutions opposed the proposed regulation in which the Secretary may require full consolidating financial statements on the grounds of expense and the possible unavailability of financial statements of such entities (because they may not be required to prepare them for any other purpose). This commenter maintained that the requirement to submit audited financial statements be limited to institutions or to an institution's parent corporation that intends to sign the institution's program participation agreement. This commenter argued that the Secretary does not have the statutory authority to require audited financial statements of related parties other than at the level of the institution, nor does the Secretary have the authority to determine the institution's financial responsibility on the basis of a related party's financial statement unless the institution is a wholly owned subsidiary of the related party. This commenter recommended that the proposed regulations be changed to limit the requirement to provide this information for related parties only if the Department reasonably believes that the related party's performance jeopardizes the financial responsibility of the institution, based on a clear financial relationship between the entities, and that the requirement be limited to the requirement that the related party provide its most recent financial statement within six months. Further, this commenter recommended that the Department not penalize the institution if the related party does not maintain sufficient documentation to support an audited financial statement.

One commenter from a proprietary institution suggested that the Department rely on the auditor's judgement, following AICPA guidelines, about whether the institution should submit consolidated financial statements. A commenter from a public institution maintained that the Department should not require a consolidated statement in situations in which such statements are not required under GASB standards.

One commenter maintained that requiring the audited financial statement from a related party could result in significant problems, stemming from requests after the year end for a period that has not been audited (resulting in difficulty in issuing a clean opinion), and the presence of inventories and opening balances that may result in qualifications. This commenter asserted that, as a result of such difficulties, the Department may not receive what it considers acceptable audits for these parties, and that institutions may not be able to correct the problems for as long as a year.

A commenter from a proprietary institution maintained that, when an institution or institutions are owned by a corporation the financial statement of the corporation be the basis for evaluating financial responsibility, since all the assets and liabilities of the institutions are assets and liabilities of the corporation.

*Discussion:* The Secretary requires that an institution provide as part of its audited financial statement a detailed disclosure of all related parties consistent with the definition of a related party established in SFAS 57. The Secretary's intent is to obtain an understanding of the relationships that exist among related entities that have the ability to exert substantial influence or control. The Secretary recognizes that

the existence of related parties may lead to material transactions that are substantially different in terms and conditions from those that would occur with unrelated independent entities. The Secretary believes that this understanding is necessary in order to take into consideration an institution's total financial circumstances. This provision is intended to make available to the Secretary information important to an analysis of the financial statements that would otherwise be difficult to ascertain simply from reviewing the financial statements. The Secretary believes that by providing a reference to the definitions in SFAS 57 both institutions and their independent auditors will have a clear understanding as to the meaning of the term ''related party'' under this provision.

To determine whether an institution is financially responsible, the Secretary may also require that the institution submit audited consolidated financial statements, audited full consolidating financial statements, audited combined financial statements or the audited financial statements of one or more related parties that have the ability, either individually or collectively, to significantly influence or control the institution, as determined by the Secretary. This requirement represents a clarification of the existing regulatory provisions in 34 CFR 668.15(e) which provides that the Secretary may request additional information to the extent necessary to make a determination of financial responsibility. The HEA requires that the Secretary take into consideration an institution's total financial circumstances. The Secretary believes that these additional financial statements may be necessary in order to obtain an understanding of the economic substance of an institution's financial condition. The Secretary further believes that this may constitute a more accurate reflection of the institution's total financial circumstances. The Secretary also believes that this provision will provide flexibility with respect to how an institution demonstrates financial responsibility. For example, the existing regulatory language may have required several institutions, none of which was individually a separate legal entity, to provide individual audited financial statements representing each institution despite the fact that all were operating divisions of a single corporate entity. Under the new standard, the Secretary has explicit flexibility to allow the preparation of a single audited financial statement, representing the corporate entity only, in lieu of requiring these individual financial statements.

Notwithstanding the Secretary's interest in obtaining an understanding of the institution's total financial circumstances, the Secretary enters into a program participation agreement with an entity that has the legal capacity and financial capability to enter into such an agreement for the institution. In the event that the Secretary determines that the economic substance of the relationship among related parties is such that the institution would not otherwise be able to demonstrate financial responsibility on its own, the Secretary may require financial guarantees from related parties or co-signatories to the program participation agreement. In contrast, should the economic relationship among related entities be such that the total financial circumstances of the institution indicate an inability to demonstrate financial responsibility due to the existence of significant liabilities or claims on the assets of the institution, the institution shall be deemed not financially responsible. The Secretary believes that this requirement will not cause excessive burden or cost to any institution that is able to demonstrate financial responsibility independently of a related entity. However, the Secretary recognizes that for some institutions this provision may be costly. The Secretary maintains that the costs are necessary to protect the federal fiscal interests.

*Changes:* The Secretary clarifies requirements in this area by adding the following regulatory language to § 668.23(d)(2): ''The disclosure requirements under this provision extend beyond those of SFAS 57 to include all related parties and a level of detail that would enable the Secretary to readily identify the related party. Such information may include but is not limited to the name, location and a description of the related entity including the nature and amount of any transactions between the related party and the institution, financial or otherwise, regardless of when they occurred.''

*Comments:* A commenter from a proprietary institution supported the requirement that proprietary institutions disclose the proportion of revenue the institution received from title IV, HEA program sources.

Many commenters opposed the requirement. Most of these commenters opposed the provision on the grounds that the current provision contained in § 600.5 requires only an attestation on the part of the CPA firm. Including a disclosure in the audited financial statement will increase the work required of the auditor as well as the exposure of the auditor, and thus increase the cost of the audit. These commenters also asserted that the current procedures provided sufficient information for the Department to fulfill its oversight responsibility in this area.

One commenter questioned whether the requirement was that the disclosure be separately audited, or based on the attestation engagement required by 34 CFR § 600.5. This commenter asserted that, should the former be the case, this should be reflected in a change to 34 CFR § 600.5 and in the Regulatory Flexibility Analysis. One commenter maintained that the request for this information suggested that the Department intended to use the information for purposes that extended beyond Congressional intent.

*Discussion:* Previously the Secretary had required an examination level ''Compliance Attestation'' to be performed within three months of the institution's fiscal year end. The Secretary believes that the revised requirement contained in these final regulations will not result in significant additional cost as the disclosure will now become part of the audit of the general purpose financial statements. The corresponding increase in cost associated with adding this disclosure is not likely to be significantly greater than the savings resulting from the removal of the requirement to perform the ''Compliance Attestation.'' Additionally, the independent auditor who performs the audit of the institution's general purpose financial statement may be able to rely to some extent on the field work of the independent auditor who will be conducting the institution's compliance audit for the same fiscal period. The Secretary requires this information to ensure compliance with provisions of the HEA that stipulate a proprietary institution may not receive more than 85 percent of total revenues in the form of Title IV program funds.

*Changes:* Section 600.5(e) has been removed.

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