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

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

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

(ii) A partnership; and

(iii) An interest in a trust.

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

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

(i) Directly or indirectly holds at least a 25 percent ownership interest in the institution or servicer;

(ii) Holds, together with other members of his or her family, at least a 25 percent ownership interest in the institution or servicer;

(iii) Represents, either alone or together with other persons under a voting trust, power of attorney, proxy, or similar agreement, one or more persons who hold, either individually or in combination with the other persons represented or the person representing them, at least a 25 percent ownership in the institution or servicer; or

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

(A) The institution or servicer; or

(B) An entity that holds at least a 25 percent ownership interest in the institution or servicer.

(4) The Secretary considers a member of a person's family to be a parent, sib-

ling, spouse, child, spouse's parent or sibling, or sibling's or child's spouse.

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

[62 FR 62877, Nov. 25, 1997, as amended at 63 FR 40348, 40349, July 28, 1998]

§ 668.175 Alternative standards and requirements.

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

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

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

(d) *Zone alternative.* (1) A participating institution that is not financially responsible solely because the Secretary determines that its composite score is less than 1.5 may participate in the title IV, HEA programs

as a financially responsible institution for no more than three consecutive years, beginning with the year in which the Secretary determines that the institution qualifies under this alternative. (i)(A) An institution qualifies initially under this alternative if, based on the institution's audited financial statement for its most recently completed fiscal year, the Secretary determines that its composite score is in the range from 1.0 to 1.4; and

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

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

(2) Under this zone alternative, the Secretary—

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

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

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

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

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

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

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

(F) Any extraordinary losses, as defined in accordance with Accounting Principles Board (APB) Opinion No. 30.

(iii) May require the institution to submit its financial statement and compliance audits earlier than the time specified under § 668.23(a)(4); and

(iv) May require the institution to provide information about its current operations and future plans.

(3) Under the zone alternative, the institution must—

(i) For any oversight or financial event described under paragraph (d)(2)(ii) of this section for which the institution is required to provide information, provide that information to the Secretary by certified mail or electronic or facsimile transmission no later than 10 days after that event occurs. An institution that provides this information electronically or by facsimile transmission is responsible for confirming that the Secretary received a complete and legible copy of that transmission; and

(ii) As part of its compliance audit, require its auditor to express an opinion on the institution's compliance with the requirements under the zone alternative, including the institution's administration of the payment method under which the institution received and disbursed title IV, HEA program funds.

(4) If an institution fails to comply with the requirements under paragraphs (d) (2) or (3) of this section, the Secretary may determine that the institution no longer qualifies under this alternative.

(e) *Transition year alternative.* A participating institution that is not financially responsible solely because the Secretary determines that its composite score is less than 1.5 for the institution's fiscal year that began on or after July 1, 1997 but on or before June 30, 1998, may qualify as a financially responsible institution under the provisions in § 668.15(b)(7), (b)(8), (d)(2)(ii), or (d)(3), as applicable.

(f) *Provisional certification alternative.* (1) The Secretary may permit an institution that is not financially responsible to participate in the title IV, HEA

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programs under a provisional certification for no more than three consecutive years if—

(i) The institution is not financially responsible because it does not satisfy the general standards under § 668.171(b) or because of an audit opinion described under § 668.171(d); or

(ii) The institution is not financially responsible because of a condition of past performance, as provided under § 668.174(a), and the institution demonstrates to the Secretary that it has satisfied or resolved that condition.

(2) Under this alternative, the institution must—

(i) Submit to the Secretary an irrevocable letter of credit that is acceptable and payable to the Secretary, for an amount determined by the Secretary that is not less than 10 percent of the title IV, HEA program funds received by the institution during its most recently completed fiscal year, except that this requirement does not apply to a public institution;

(ii) Demonstrate that it was current on its debt payments and has met all of its financial obligations, as required under § 668.171 (b)(3) and (b)(4), for its two most recent fiscal years; and

(iii) Comply with the provisions under the zone alternative, as provided under paragraph (d) (2) and (3) of this section.

(3) If at the end of the period for which the Secretary provisionally certified the institution, the institution is still not financially responsible, the Secretary may again permit the institution to participate under a provisional certification, but the Secretary—

(i) May require the institution, or one or more persons or entities that exercise substantial control over the institution, as determined under § 668.174(b)(1) and (c), or both, to submit to the Secretary financial guarantees for an amount determined by the Secretary to be sufficient to satisfy any potential liabilities that may arise from the institution's participation in the title IV, HEA programs; and

(ii) May require one or more of the persons or entities that exercise substantial control over the institution, as determined under § 668.174(b)(1) and (c), to be jointly or severally liable for any

liabilities that may arise from the institution's participation in the title IV, HEA programs.

(g) *Provisional certification alternative for persons or entities owing liabilities.* (1) The Secretary may permit an institution that is not financially responsible because the persons or entities that exercise substantial control over the institution owe a liability for a violation of a title IV, HEA program requirement, to participate in the title IV, HEA programs under a provisional certification only if—

(i)(A) The persons or entities that exercise substantial control, as determined under § 668.174(b)(1) and (c), repay or enter into an agreement with the Secretary to repay the applicable portion of that liability, as provided under § 668.174(b)(2)(ii); or

(B) The institution assumes that liability, and repays or enters into an agreement with the Secretary to repay that liability;

(ii) The institution satisfies the general standards and provisions of financial responsibility under § 668.171(b) and (d)(1), except that institution must demonstrate that it was current on its debt payments and has met all of its financial obligations, as required under § 668.171 (b)(3) and (b)(4), for its two most recent fiscal years; and

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

(2) Under this alternative, the Secretary—

(i) Requires the institution to comply with the provisions under the zone alternative, as provided under paragraph (d) (2) and (3) of this section;

(ii) May require the institution, or one or more persons or entities that exercise substantial control over the institution, or both, to submit to the Secretary financial guarantees for an amount determined by the Secretary to be sufficient to satisfy any potential liabilities that may arise from the institution's participation in the title IV, HEA programs; and

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(iii) May require one or more of the persons or entities that exercise substantial control over the institution to be jointly or severally liable for any liabilities that may arise from the insti-

tution's participation in the title IV, HEA programs.

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

[62 FR 62877, Nov. 25, 1997, as amended at 63 FR 40348, 40349, July 28, 1998]

APPENDIX A TO SUBPART L OF PART 668—RATIO METHODOLOGY FOR PROPRIETARY INSTITUTIONS

Section 1: Ratios and Ratio Terms

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

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

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

Definitions:

Adjusted Equity = (total owner's equity) - (intangible assets) - (unsecured related-party receivables) - (net property, plant and equipment)* + (post-employment and retirement liabilities) + (all debt obtained for long-term purposes)**

Total Expenses excludes income tax, discontinued operations, extraordinary losses, or change in accounting principle.

Modified Equity = (total owner's equity) - (intangible assets) - (unsecured related-party receivables)

Modified Assets = (total assets) - (intangible assets) - (unsecured related-party receivables)

Income Before Taxes is taken directly from the audited financial statement

Total Pre-Tax Revenues = (total operating revenues) + (non-operating revenues and gains). Investment gains should be recorded net of investment losses. No revenues shown after income taxes (e.g., discontinued operations, extraordinary gains, or change in accounting principle) on the income statement should be included.

* The value of plant, property and equipment is net of accumulated depreciation, including capitalized lease assets.

** The value of all debt obtained for long-term purposes includes the short-term portion of the debt, up to the amount of net property, plant and equipment.

Section 2. Calculating the Ratios from the Balance Sheet and Income Statement

Balance Sheet	
Line	
1	Cash \$ 190,000
2	Accounts Receivable 1,010,000
3	Prepaid Expenses 150,000
4	Inventories 130,000
5	Note Receivable from Affiliate 200,000
6	Investments 330,000
7	Total Current Assets 2,010,000
8	Property and Equipment, net 500,000
9	Amount Due from Owner 170,000
10	Goodwill 80,000
11	Organization Costs 70,000
12	Deposits 60,000
13	Total Assets 2,890,000
14	Accounts Payable 200,000
15	Accrued Expenses 330,000
16	Current Portion of Long-Term Debt 120,000
17	Deferred Revenue 650,000
18	Total Current Liabilities 1,300,000
19	Long-Term Debt, net of Current Portion 330,000
20	Total Liabilities 1,630,000
21	Contributed Capital 440,000
22	Retained Earnings 820,000
23	Total Owner's Equity 1,260,000
24	Total Liabilities and Owner's Equity 2,890,000

Statement of Income and Retained Earnings	
Line	
25	Operating Income \$ 9,700,000
26	Non-Operating Income 300,000
27	Total Income 10,000,000
28	Cost of Goods Sold 6,800,000
29	Administrative Expenses 2,600,000
30	Depreciation Expense 60,000
31	Interest Expense 40,000
32	Total Expenses 9,500,000
33	Other: Gain on Sale of Investments 10,000
34	Net Income Before Taxes 510,000
35	Federal Income Taxes 153,000
36	Net Income After Taxes 357,000
37	Extraordinary Loss, net of tax 800,000
38	Net Income (643,000)
39	Retained Earnings, beginning of year 1,263,000
22	Retained Earnings, end of year 820,000

$$\text{Primary Reserve Ratio} = \frac{\text{lines 25-26} + \text{lines 16+19}}{\text{line 32}} = \frac{\$ 760,000}{\$ 9,500,000} = 0.080$$

$$\text{Equity Ratio} = \frac{\text{lines 23+24}}{\text{lines 13+14+15}} = \frac{\$ 810,000}{\$ 2,440,000} = 0.332$$

$$\text{Net Income Ratio} = \frac{\text{line 34}}{\text{line 27+33}} = \frac{\$ 510,000}{\$ 1,010,000} = 0.051$$

*Long-Term Debt (lines 16 + 19) cannot exceed Property and Equipment (line 8) in this formula

Section 3: Calculating the Composite Score

Step 1: Calculate the strength factor score for each ratio, by using the following algorithms:

Example (for Proprietary institutions)

Primary Reserve strength factor score = $20 \times$ Primary Reserve ratio result: $20 \times 0.080 = 1.600$

Equity strength factor score = $6 \times$ Equity ratio result: $6 \times 0.332 = 1.992$

Net Income strength factor score = $1 + (33.3 \times$ Net Income ratio result): $1 + (33.3 \times 0.051) = 2.698$

If the strength factor score for any ratio is greater than or equal to 3, the strength factor score for that ratio is 3. If the strength factor score for any ratio is less than or equal to -1, the strength factor score for that ratio is -1.

Step 2: Calculate the weighted score for each ratio and calculate the composite score by adding the three weighted scores

Primary Reserve weighted score = $30\% \times$ Primary Reserve strength factor score: $0.30 \times 1.600 = 0.480$

Equity weighted score = $40\% \times$ Equity strength factor score: $0.40 \times 1.992 = 0.797$

Net Income weighted score = $30\% \times$ Net Income strength factor score: $0.30 \times 2.698 = 0.809$

Composite score = sum of all weighted scores: $0.480 + 0.797 + 0.809 = 2.086$

Round the composite score to one digit after the decimal point to determine the final score: 2.1

* The symbol "x" denotes multiplication.

[62 FR 62882, Nov. 25, 1997. Redesignated at 65 FR 65650, Nov. 1, 2000]

APPENDIX B TO SUBPART L OF PART 668—RATIO METHODOLOGY FOR PRIVATE
NON-PROFIT INSTITUTIONS

Section 1: Ratios and Ratio Terms

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

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

$$\text{Net Income Ratio} = \frac{\text{Change in Unrestricted Net Assets}}{\text{Total Unrestricted Revenue}}$$

Definitions:

Expendable Net Assets = (unrestricted net assets) + (temporarily restricted net assets) - (annuities, term endowments, and life income funds that are temporarily restricted) - (intangible assets) - (net property, plant and equipment)* + (post-employment and retirement liabilities) + (all debt obtained for long-term purposes)** - (unsecured related-party receivables)

Total Expenses is total unrestricted expenses taken directly from the audited financial statement

Modified Net Assets = (unrestricted net assets) + (temporarily restricted net assets) + (permanently restricted net assets) - (intangible assets) - (unsecured related-party receivables)

Modified Assets = (total assets) - (intangible assets) - (unsecured related-party receivables)

Change in Unrestricted Net Assets is taken directly from the audited financial statement

Total Unrestricted Revenue is taken directly from the audited financial statement (This amount includes net assets released from restriction during the fiscal year)

* The value of plant, property and equipment is net of accumulated depreciation, including capitalized lease assets.

** The value of all debt obtained for long-term purposes includes the short-term portion of the debt, up to the amount of net property, plant and equipment.

Section 2, Calculating the Ratios from the Balance Sheet and Statement of Activities

Statement of Activities
column: 4

Line	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
27	\$45,000,000			\$45,000,000
28	1,200,000	\$ 300,000	\$ 120,000	1,620,000
29	5,500,000			5,500,000
30	200,000			200,000
31	51,980,000	300,000	120,000	52,320,000
32	38,000,000			38,000,000
33	5,000,000			5,000,000
34	2,880,000			2,880,000
35	5,200,000			5,200,000
36	900,000			900,000
37		200,000		200,000
38	51,980,000	200,000		52,180,000
39	(80,000)	100,000		20,000
40	15,270,000	2,700,000	8,880,000	26,850,000
41	15,190,000	2,800,000	9,000,000	26,990,000

Primary Reserve Ratio = (lines) $\frac{20+23+21+10+8+18}{38a} = \frac{\$ 9,790,000}{\$ 51,980,000} = 0.188$

Equity Ratio = (lines) $\frac{25+10}{12+10} = \frac{\$ 26,490,000}{\$ 75,740,000} = 0.350$

Net Income Ratio = (lines) $\frac{10+}{31a} = \frac{\$ (80,000)}{\$ 51,980,000} = (0.0015)$

* In accounting statements, parentheses denote negative numbers (i.e., (80,000) equals negative 80,000).

** Long-Term Debt (line 18) cannot exceed Property and Equipment, net (line 8) in this formula.

Line	Total
1	\$ 1,000,000
2	6,000,000
3	1,500,000
4	500,000
5	2,000,000
6	8,000,000
7	6,000,000
8	50,000,000
9	720,000
10	500,000
11	20,000
12	76,240,000
13	\$ 500,000
14	2,000,000
15	3,500,000
16	650,000
17	6,600,000
18	36,000,000
19	49,250,000
20	15,190,000
21	300,000
22	2,500,000
23	2,800,000
24	9,000,000
25	26,990,000
26	76,240,000

Section 3: Calculating the Composite Score

Step 1: Calculate the strength factor score for each ratio, by using the following algorithms

Primary Reserve strength factor score = 10 x Primary Reserve ratio result:
 Example (for Private Non-Profit institutions)
 $10 \times 0.188 = 1.880$

Equity strength factor score = 6 x Equity ratio result:
 $6 \times 0.350 = 2.100$

Because the Net Income ratio result is negative, the algorithm for negative net income is used -- Net Income strength factor score = 1 + (25 x Net Income ratio result):
 $1 + (25 \times -0.0015) = 0.963$

(Note: If the Net Income ratio result is positive, the following algorithm is used, Net Income strength factor score = 1 + (50 x Net Income ratio result) -- If the Net Income ratio result is 0, the Net Income strength factor score is 1).

If the strength factor score for any ratio is greater than or equal to 3, the strength factor score for that ratio is 3. If the strength factor score for any ratio is less than or equal to -1, the strength factor score for that ratio is -1.

Step 2: Calculate the weighted score for each ratio and calculate the composite score by adding the three weighted scores

Primary Reserve weighted score = 40% x Primary Reserve strength factor score:
 $0.40 \times 1.880 = 0.752$

Equity weighted score = 40% x Equity strength factor score:
 $0.40 \times 2.100 = 0.840$

Net Income weighted score = 20% x Net Income strength factor score:
 $0.20 \times 0.963 = 0.193$

Composite score = sum of all weighted scores:
 $0.752 + 0.840 + 0.193 = 1.785$

Round the composite score to one digit after the decimal point to determine the final score:
 1.8

* The symbol "x" denotes multiplication.

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