
AUDIT OF
CAPITAL CITY TRADE AND TECHNICAL
SCHOOL, INC.
COMPLIANCE WITH THE
85 PERCENT RULE

FINAL AUDIT REPORT



Control Number ED-OIG/A06-80008

February 2000

Our mission is to promote the efficient
and effective use of taxpayer dollars
in support of American education.



U.S Department of Education
Office of Inspector General
Dallas, Texas

NOTICE

Statements that management practices need improvement, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determination of corrective action to be taken will be made by the appropriate Department of Education officials.

In accordance with the Freedom of Information Act (5 U.S.C. §552), reports issued by the Office of Inspector General are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

FEB 15 2000

Control Number ED-OIG/A06-80008

Mr. Robert Holt, President
Capital City Trade and Technical School
5424 Highway 290 West, Suite 111
Austin, Texas 78735

Dear Mr. Holt:

This is our audit report, *Capital City Trade and Technical School, Inc. Compliance with the 85 Percent Rule*. The report incorporates the comments you provided in response to the draft report. If you have any additional comments or information that you believe may have a bearing on the resolution of this audit, you should send them directly to the following U.S. Department of Education official, who will consider them before taking final Departmental action on the audit:

Mr. Greg Woods, Chief Operating Officer
Student Financial Assistance
ROB-3, Room 4004
7th and D Streets, SW
Washington, DC 20202-5132

Office of Management and Budget Circular A-50 directs Federal agencies to expedite the resolution of audits by initiating timely action on the findings and recommendations contained therein. Therefore, we request receipt of your comments within 30 days.

In accordance with the Freedom of Information Act (5 U.S.C. §552), reports issued by the Office of Inspector General are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

Please refer to the above audit control number in all correspondence relating to this report.

Sincerely,

Lorraine Lewis

TABLE OF CONTENTS

| | |
|-----------------------------------------------------------------------------------------------------------------------------------------|----|
| EXECUTIVE SUMMARY | 1 |
| AUDIT RESULTS | 2 |
| Proprietary Schools are Required to Generate at least 15 percent of Revenue from Non-Title IV Sources | 2 |
| Proceeds from the Sale of Delinquent Student Accounts between Related Parties were Improperly Included as Non-Title IV Revenue | 3 |
| The Related Parties and Their Relationships | 4 |
| The Sale of Delinquent Student Accounts between Related Parties | 4 |
| SEOG Matching Funds Included as Non-Title IV Revenue | 5 |
| RECOMMENDATIONS | 7 |
| CAPITAL CITY’S RESPONSE TO DRAFT REPORT | 7 |
| OIG RESPONSE TO COMMENTS | 8 |
| BACKGROUND | 10 |
| OBJECTIVE, SCOPE, AND METHODOLOGY | 10 |
| STATEMENT ON MANAGEMENT CONTROLS | 11 |
| APPENDIX I | |
| APPENDIX II | |

EXECUTIVE SUMMARY

Capital City Trade and Technical School, Inc. (Capital City), a proprietary institution located in Austin, Texas, did not qualify as an eligible institution for participation in the Title IV, Student Financial Assistance Programs because it received 87.84 percent of its revenue from Title IV sources during its fiscal year ended December 31, 1997. As a result, Capital City was ineligible to participate in the Title IV programs for the period January 1 through December 31, 1998. Capital City received \$551,259 in Federal Pell Grant and Federal Campus Based Program funds, and \$1,481,322 in Federal Family Education Loan Program (FFELP) funds during this period.

Section 481(b) of the Higher Education Act in effect during our audit period, required that proprietary institutions derive at least 15 percent of their revenues from non-Title IV sources to participate in the Title IV programs. Conversely, no more than 85 percent of total revenue could be derived from the Title IV programs. This institutional eligibility requirement was commonly referred to as the 85 Percent Rule. Capital City reported that it met the requirements of the 85 Percent Rule in the "Notes to Financial Statements" for its fiscal year ending December 31, 1997. However, Capital City improperly included \$84,429 as non-Title IV revenue. This amount resulted from transactions between Capital City and a related party that had a controlling and ownership interest in the institution. Therefore, there was no increase in revenue to the institution. Capital City also improperly included \$24,209 in Federal Supplemental Education Opportunity Grant (SEOG) matching funds in the non-Title IV component of the 85 Percent Rule calculation.

We recommend that the Chief Operating Officer for Student Financial Assistance initiate action to terminate Capital City from participation in the Title IV programs unless Capital City can demonstrate that it met eligibility requirements for its fiscal year ended December 31, 1998. The Chief Operating Officer should also require that Capital City return to the Department or lenders \$551,259 in Federal Pell Grant and Federal Campus Based Program funds and \$1,481,322 in FFELP funds that the school received from January 1 through December 31, 1998 while it was an ineligible institution.

Capital City did not agree with our findings and recommendations. The school's response did not convince us to change our recommendations. We have paraphrased the school's comments and provided additional OIG comments after the Recommendation section of this report. A copy of the response is included as Appendix I to this report. Copies of exhibits that were also included with the response are available on request.

AUDIT RESULTS

We concluded that Capital City did not derive 15 percent of its revenues from non-Title IV sources during its fiscal year ended December 31, 1997 and therefore was not eligible to participate in the Title IV programs for the period January 1 through December 31, 1998. Capital City received \$551,259 in Federal Pell Grant and Federal Campus Based Program funds and \$1,481,322 in Federal Family Education Loan Program funds during that period. Capital City reported that it received 83.3 percent of total revenue from Title IV sources in its 1997 financial statements. Capital City actually received 87.84 percent of its total revenue from Title IV sources because it improperly included \$84,429 as non-Title IV revenue. These funds resulted from transactions with a related party that had an ownership interest in Capital City and exercised control over the day-to-day operations of the institution. As a result, the transactions did not represent an increase in revenue to the institution. Capital City also included \$24,209 of SEOG matching funds in its calculation which did not represent revenue received from a source independent of the institution.

Proprietary Schools are Required to Generate at least 15 percent of Revenue from Non-Title IV Sources.

The Higher Education Act (HEA), Section 481(b), in effect during the audit period stated: . . . *the term proprietary institution of higher education means a school . . . which has at least 15 percent of its revenues from sources that are not derived from [HEA, Title IV] funds . . .* This institutional eligibility requirement is codified in Title 34 of the Code of Federal Regulations (CFR), Section 600.5(a)(8), and is commonly referred to as the 85 Percent Rule. The regulations also provide the formula, at 34 CFR 600.5(d)(1), for assessing whether an institution has satisfied the requirement and specifies that amounts used in the formula must be received by the institution during its fiscal year. The formula is as follows:

Title IV, HEA program funds the institution used to satisfy tuition, fees, and other institutional charges to students

The sum of revenues generated by the institution from: Tuition, fees, and other institutional charges for students enrolled in eligible programs as defined in 34 CFR 668.8; and activities conducted by the institution, to the extent not included in tuition, fees, and other institutional charges, that are necessary for the education or training of its students who are enrolled in those eligible programs

***Proceeds from the Sale
of Delinquent Student
Accounts between
Related Parties were
Improperly Included as
Non-Title IV Revenue***

Capital City improperly included \$84,429 in its 85 Percent Rule calculation. These funds were received from a related party with a controlling and ownership interest in the institution. The regulations provide that revenues included in the calculation are limited to revenues generated for the training of students and received from Title IV sources or from sources independent of the institution.

In February 1994, the Department published the proposed regulations to implement this portion of the Higher Education Act. In the preamble, the Secretary stated that the purpose of the new statutory criterion was to require proprietary institutions to attract students based on the quality of their programs and not solely because the institutions offer Federal student financial assistance. In proposing this rule, the Secretary was required by the Higher Education Act to interpret the term revenue and chose to limit revenues received to tuition and fees plus revenues from other activities carried out by the institution that were necessary to the education or training offered by these institutions.

The preamble provides that proprietary institutions should satisfy a portion of the 85 Percent Rule revenue requirement with funds from non-Title IV programs or from private sources that are independent of the institution.

Title 34 CFR 600.31(b) defines control and ownership of an institution as:

Control (including the terms “controlling”, “controlled by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise Person includes a legal person (corporation or partnership) or an individual.

Ownership or ownership interest means a legal or beneficial interest in an entity, or a right to share in the profits derived from the operation of an entity

The Related Parties and Their Relationships

Capital City Trade and Technical School, Inc. owns and operates two separate institutions under the single OPE ID Number 02074100. The corporation and its two institutions, Capitol City Trade and Technical School and Allied Health Careers are collectively referred to as Capital City. The stock in Capital City is owned 50 percent by **Owner A** and 50 percent by **Owner B**. **Owner A** serves as the president of Capital City.

Timberline I is a general partnership. The partners are two privately held corporations. The two corporate partners are RCH Enterprises, Inc. and Berry Enterprises, Inc. with RCH Enterprises, Inc. designated as the managing partner. RCH Enterprises, Inc. is an **Owner A** family owned corporation with **Owner A** as the president. Berry Enterprises, Inc. is an **Owner B** family owned corporation with **Owner B** as the president.

As outlined above, **Owner A** has direct control of and a significant ownership interest in both Capital City and Timberline I (See Appendix II for a diagram of the relationship).

In a management agreement signed in 1983, Capital City contracted with Timberline I to manage all aspects of Capital City's operations. **Owner A** signed the agreement for both Capital City and Timberline I. Under the agreement, Timberline I manages accounts receivable for Capital City. **Owner A**, as president of RCH Enterprises, Inc., the managing partner for Timberline I, and as president of Capital City makes management decisions for both entities. Thus, Timberline I has a controlling interest in Capital City.

The management agreement calls for Timberline I to be paid a management fee of 13 percent of gross receipts and a share in the profits of the institution. During the institution's 1997 fiscal year, Timberline I received \$771,285 in management fees. Thus, Timberline I exhibits an ownership interest in Capital City by having a right to share in the proceeds of the institution.

***The Sale of Delinquent
Accounts between
Related Parties***

Capital City included \$84,429 that it received from Timberline I as non-Title IV revenue in its 85 Percent Rule calculation. Timberline I purchased student accounts from the institution on December 17, 1997 – just two weeks prior to the end of the institution’s fiscal year.

Even though the student accounts had been written off as bad debt, Timberline I paid a price equal to 80 percent of the face value for the student accounts. We found no evidence that the bad debt was rehabilitated prior to the purchase. Timberline I subsequently placed the delinquent accounts with a collection agency that was entitled to keep one-third of the collections that it made. The placement of the accounts with the collection agency would result in a loss to Timberline I, even if all the delinquent accounts were successfully collected. The \$84,429 sale of delinquent accounts should be excluded from Capital City’s 85 Percent Rule calculation for 1997 because it does not represent revenue to the institution from a source that is independent of the institution. The common ownership of Capital City and Timberline I, the sale of delinquent accounts for a price exceeding the buyer’s potential recoveries, the same individual acting as buyer and seller, and the December 17, 1997 date of sale all support the conclusion that the cash from the sale of bad debt should not be treated as revenue received by Capital City for educational programs. We reduced the denominator by the amount of the proceeds from the sale as shown in the Table on page six.

***SEOG Matching Funds
Included as Non-Title
IV Revenue***

Capital City included SEOG matching funds of \$24,209 in its non-Title IV revenue. Matching funds are not considered revenue from sources independent of the institution and should not be included as non-Title IV revenue. We reduced the denominator by the amount of the overstatement as shown in the Table. Revenue does not result when an institution simply transfers funds from one account to another account.

TABLE
Capital City and OIG Calculated Percentages of Title IV Revenue
January 1, 1997 to December 31, 1997.

| Funding Source | Capital City Calculation | Funds from Related Party | SEOG Matching | OIG Calculation |
|-------------------------------------------------------|---------------------------------|---------------------------------|----------------------|------------------------|
| Title IV Receipts | \$1,774,465 | | | \$1,774,465 |
| Non-Title IV Receipts | \$354,302 | (\$84,429) | (\$24,209) | \$245,664 |
| Total Revenue (Cash Basis) | \$2,128,767 | (\$84,429) | (\$24,209) | \$2,020,129 |
| Title IV Revenue as a Percent of Total Revenue | 83.36 % | | | 87.84% |

The Table illustrates that Title IV revenues represented 87.84 percent of total revenue and not the reported 83.36 percent. Institutions that fail to satisfy the 85 Percent Rule lose their eligibility to participate in Title IV programs on the last day of the fiscal year covering the period that the institution failed to meet the requirement [34 CFR 600.40(a)(2)]. As a result, Capital City lost its eligibility to participate as of December 31, 1997.

Capital City received \$551,259 in Federal Pell Grant and Federal Campus Based Program funds and \$1,481,322 in FFELP funds between January 1 and December 31, 1998, based on data obtained from the Department.

RECOMMENDATIONS

We recommend that the Chief Operating Officer for Student Financial Assistance:

1. Initiate action to terminate Capital City from participation in the Title IV programs unless Capital City can demonstrate that it met eligibility requirements for its fiscal year ended December 31, 1998.
2. Require that Capital City return to the Department \$551,259 of Federal Pell Grant and Federal Campus Based Program funds received during the period January 1 through December 31, 1998.
3. Require that Capital City return to lenders \$1,481,322 of FFELP funds received during the period January 1 through December 31, 1998. This amount does not include loan origination fees, interest, or special allowance costs incurred by the Department for the loans.

CAPITAL CITY'S RESPONSE TO DRAFT REPORT

Capital City disagreed with our conclusion that the institution did not comply with the 85 Percent Rule for the fiscal year ending December 31, 1997. A copy of the letter from Capital City is included as Appendix I to this report. Exhibits that were included with the letter are available on request.

Capital City officials argued that they correctly calculated the non-Title IV revenues and complied with the 85 Percent Rule for fiscal year 1997. Capital City officials further stated that due to the OIG's different interpretation of revenue, . . . *OIG excluded SEOG matching funds and certain cash receipts from total revenue received for tuition and fees.* Capital City also contended that . . . *its accountant calculated the 85/15 percentage in good faith and without adequate guidance from the Department or OIG . . .* and that . . . *Good faith and reasonable interpretations of the law should be entitled to be made without threat of penalty . . .*

Capital City officials said that SEOG matching funds were properly included in the denominator of the 85/15 calculation because, while the Secretary stated that they should be excluded from the numerator, he did not specifically exclude matching funds from the denominator.

Capital City officials did not address the issue of the independence of the related party. Instead, they stated that the inclusion of the revenue from the related party in the 85/15 calculation was proper because the transaction was a . . . *legitimate transaction that was made in good faith. . . the transaction was part of a planned effort to increase availability to and use of non-Title IV financing alternatives for the students . . .* Capital City officials also stated there is no . . . *proscription on such a transaction within the context of Title IV.*

The Draft Report contained no finding related to institutional or third party loans. Nevertheless, Capital City's response included the argument that it used a very conservative approach to the 85 Percent Rule calculations because it included only the payments received during fiscal year 1997 from students on their institutional and third party loans. Capital City officials identified 74 students who received institutional or third party loans. Capital City officials argue that the institution was entitled to and could have properly included the face value of the institutional and third party loans to the 74 students in its calculation. If it had done so, it would have included an additional \$81,874 in non-Title IV revenue thereby complying . . . *with the 85 Percent Rule for FY 1997 with a percentage of 83.3, even allowing for the exclusion by the OIG of \$84,429 relating to the sale of accounts.*

Capital City officials stated that the institution met the 90 Percent Rule in fiscal year 1998. *While the 90 Percent Rule was not in effect for Fiscal Year 1997, Capital City considers the fact that it met the new Rule in those years a relevant consideration especially given Congress' clear action modifying the rule to 90/10 since the 85 Percent Rule was too restrictive.*

OIG RESPONSE TO COMMENTS

Capital City's comments did not persuade us to change our findings or recommendations.

SEOG Matching. In the preamble to the regulation, the Secretary did state that SEOG (and Perkins) matching funds should not be included in the numerator of the 85/15 calculation. However, the absence of a statement regarding the denominator does not negate the fact that matching funds represent cash transfers between institutional accounts. These transfers do not result in revenue from sources independent of the institution.

Related Party. Due to the common ownership of the institution and the related party, the purchase of delinquent accounts does not represent revenues to the institution from a source independent of the institution. Capital City's comments did not address the issue of revenues from a source that was not independent of the institution.

Outstanding Loan Balances. Capital City claimed that it had found additional revenue for fiscal year 1997 of \$81,874 in unpaid principal of institutional and third party loans to 74 students. We returned to the school and determined that the \$81,874 did not represent revenue to the institution during fiscal year 1997. The regulations state that . . . *the title IV, HEA program funds included in the numerator and the revenue included in the denominator are the amount of title IV, HEA program funds and revenues received by the institution during the institution's last complete fiscal year.* [34 CFR 600.5(d)(2)(i)]. The unpaid loan principal claimed as revenue by the institution for fiscal year 1997 was not received as of December 31, 1997, nor was it unpaid loan principal.

The "loans" identified by Capital City officials were actually unpaid balances on retail installment agreements as of December 31, 1997. The regulations stipulate that the revenue to include in the denominator is the sum of revenues generated by the institution from tuition, fees, and other institutional charges. Only those amounts from institutional loans that are used to satisfy tuition, fees, and other institutional charges may be included in the calculation. The student ledger cards did reflect amounts owed to Capital City for tuition and fees. However, there was no indication of institutional or third party loan proceeds paid to the student. In addition, there was no evidence of promissory notes or similar documents in the student files. We determined that none of the amounts claimed by Capital City as additional loan principal were credited to student accounts for tuition, fees, or other institutional charges.

We did find an "Installment Note and Disclosure Statement" (installment agreement) in 24 of the 25 files reviewed. The installment agreements included statements about the credit that was being extended: *The amount of credit provided to you . . . , . . . The dollar amount the credit will cost you . . . and . . . The cost of your credit as a yearly rate.* The documents contained no indication that the school was loaning money to the student. Rather, the documents were prepared for students to show the total amount of credit they were being advanced. The installment agreements generally identified the number and amount of payments the students would have to make to satisfy the credit agreement. Based on our sample review, payments on these installment contracts were credited to student accounts as the school received them. We allowed payments made by students on installment agreements as non-Title IV revenue in our calculations during the audit because the payments were used to satisfy tuition, fees, and other institutional charges.

BACKGROUND

Capital City Trade and Technical School, Inc. was incorporated in 1972 and operates as a proprietary institution located in Austin, Texas. Capital City received initial approval to participate in the Title IV programs in January 1988, and is accredited by the Accrediting Commission on the Council on Occupational Education. The institution offers vocational programs in Medical Assistant, Dental Assistant, Automotive Technician, Welding, Drafting, and Air Conditioning, Heating and Refrigeration Technician.

During January 1, 1997 through December 31, 1998, Capital City received \$3,807,046 of Federal Pell Grant Program, Federal Campus Based Program, and Federal Family Education Loan Program funds.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our audit was to determine whether Capital City derived at least 15 percent of its revenues from non-Title IV sources and properly reported its 85 Percent Rule percentage in its audited financial statements.

To accomplish our objective, we obtained background information about the institution. We reviewed selected Capital City files and Department records. We reviewed Capital City's fiscal year 1997 corporate financial statements and Student Financial Assistance (SFA) compliance audit report prepared by its CPA. We also conducted interviews with Capital City officials.

We performed an analysis of and used information extracted from Capital City's computerized database. The reliability of the computerized information was tested by verifying selected data with other sources such as institutional bank statements and student records. We concluded that the computerized information was sufficiently reliable for the purposes of our audit. We also used data applicable to the school that we obtained from the Department's National Student Loan Data System, Payment Management System, and Grants Administration and Payment System.

Our audit covered the institution's fiscal year ending December 31, 1997. In addition, we reviewed the school's 85 Percent Rule calculation for 1996 to determine whether the school included revenue from related parties and found that it had not. We performed fieldwork at Capital City from June 29, 1998 through November 18, 1998. We revisited the school on September 8, 1999 to evaluate elements of Capital City's response to our draft report. Our audit was performed in accordance with generally accepted government auditing standards appropriate to the scope of the review described above.

STATEMENT ON MANAGEMENT CONTROLS

As part of our review, we assessed Capital City's management control structure, as well as its policies, procedures, and practices applicable to the scope of the audit. For the purpose of this report, we assessed management controls related to the institution's calculation and reporting of the percentage of revenues received from non-Title IV sources as required by the 85 Percent Rule.

Because of inherent limitations, a study and evaluation made for the limited purposes described above would not necessarily disclose all material weaknesses in the control structure. However, our assessment disclosed weaknesses in the procedures used to calculate the percentage. The weaknesses are discussed in the Audit Results section of this report.

APPENDIX I

RITZERT & LEYTON

A PROFESSIONAL CORPORATION

ATTORNEYS AT LAW

SUITE 200

10387 MAIN STREET

FAIRFAX, VIRGINIA 22030

TELEPHONE (703) 934-2660

FACSIMILE (703) 934-9840

gritzert@ritzert-leyton.com

August 27, 1999

OF COUNSEL
DAVIS & BENIZEN

DISTRICT OF COLUMBIA ADDRESS
SUITE 1075

888 SEVENTEENTH STREET, N.W.
WASHINGTON, D.C. 20006

DIRECT 934-9827

STEVEN M. GOMBOS
J. CARLTON HOWARD, JR.[▲]
PETER S. LEYTON*
GERALD M. RITZERT+
JOHN E. RITZERT, JR.*+
DAVID A. ROLL

JAMES F. MCGOWAN III[▲]

* ALSO ADMITTED IN D.C.

+ ALSO ADMITTED IN MARYLAND

▲ ALSO ADMITTED IN NEW YORK

VIA OVERNIGHT MAIL

Mr. Daniel J. Thaens
Western Area Audit Manager
U.S. Department of Education
Office of Inspector General
1999 Bryan Street, Harwood Center
Suite 2630
Dallas, Texas 75201-6817

Re: Capitol City Trade and Technical School – Response to Draft Audit

Dear Mr. Thaens:

As you know, this Firm represents Capitol City Trade and Technical School. Please find attached Capitol City's response, with exhibits, to the draft Office of Inspector General Report (ACN 06-80008).

If you have any questions, please feel free to contact me.

Very truly yours,


Gerald M. Ritzert

Enclosure

c: Mr. Robert C. Holt

APPENDIX I

CAPITAL CITY TRADE AND TECHNICAL SCHOOL, INC.'S RESPONSE TO THE OFFICE OF INSPECTOR GENERAL'S DRAFT AUDIT REPORT ACN 06-80008

I. PRELIMINARY STATEMENT

On June 30, 1999, the U.S. Department of Education Office of Inspector General ("OIG") issued a draft audit report to Capital City Trade and Technical School, Inc., d/b/a Capitol City ("Capitol City" or the "School"), Audit Control Number 06-80008 ("Draft Audit", *Exhibit 1*). The Draft Audit focused solely upon Capitol City's compliance with what is commonly referred to as the 85 Percent Rule.¹

The Draft Audit concluded that the percentage of Capitol City's non-Title IV revenue for fiscal year 1997 did not achieve the minimum non-Title IV revenue threshold of 15 percent.² Capitol City's audited financial statements, prepared by Salmon, Beach & Company, P.C. ("SBC"), reported the Institution's Title IV revenue percentages for fiscal year 1997 as 83.3%. *Exhibit 1 at 2, Exhibit 2, note 13*. OIG asserts in the Draft Audit that Capitol City derived 87.84% of its revenue from Title IV sources. *Exhibit 1 at page 2*.

OIG and SBC reached contrary results due to different interpretations of the revenues contained in the denominator of the 85/15 calculation. Principally, the difference occurs because OIG excluded SEOG matching funds and certain cash receipts from the total revenue received for tuition and fees. *Exhibit 1 at 2-6*.

OIG recommends that the Office of Student Financial Assistance ("OSFA") take action to terminate Capitol City's participation in the Title IV programs unless it demonstrates that it met the 90 Percent Rule for fiscal year 1998. OIG also recommends that Capitol City return about \$2 million in combined Title IV grants and loans disbursed during fiscal years 1997. *Exhibit 1 at 6*.

Capitol City received 84.5% of its revenue from Title IV in fiscal year 1998. *Exhibit 3, note 13*. This is well within the 90 Percent Rule limitation. Capitol City

¹ Under the 85 Percent Rule, at least 15 percent of a proprietary school's revenue had to be derived from non-Title IV sources. 20 U.S.C. § 1088(b)(6)(section 481(b)(6) of the HEA) and 34 C.F.R. § 600.5(a)(8). On October 7, 1998, the HEA was reauthorized as part of which this provision was amended to require that at least 10 percent of a proprietary school's revenue has to be derived from non-Title IV sources. Section 102 of the Higher Education Amendments of 1998. The Department has not issued any formal guidance with respect to the effective date of this provision, however, it has informally advised the affected community that the 10 percent rule is effective with respect to any fiscal year ending on or after October 7, 1998.

² The Institute's Title IV revenue percentages for FY 1996 and FY 1997, according to the Draft Audit, are 86.73% and 87.56%, respectively. *Exhibit 1 at 2*.

APPENDIX I

correctly calculated its Title IV and non-Title IV revenue and complied with the 85 Percent Rule for fiscal years 1997.³

As exhibited in this response, Capitol City accurately interpreted the law. In addition, it relied in good faith upon the limited available guidance from the Department and its accountants. OIG conclusions and recommendations are unfounded, inappropriate, and do not support the sanctions it seeks.

II. BACKGROUND

Capitol City was founded in 1965 under the name Texas Vocational School. Initially, only one course of study was offered and it was in conjunction with government-sponsored programs. After some intervening name changes, the current name was adopted in March 1972. The facilities currently in use were acquired in April 1973. Contrary to the initial predominance in government-sponsored programs, the current student enrollment is largely private. See *Exhibit 5 - 1998-99 Catalog*. The Accrediting Commission of the Council on Occupational Education accredits Capitol City. Capitol City is also approved and regulated by the Texas Workforce Commission.

Capitol City offers education in the areas of Automotive Technician, Drafting/Computer Assisted Drafting, Welding and Air Conditioning, Heating, Refrigeration and Appliance programs and Allied Health Careers offers education in Medical Assisting and Dental assisting. Each program is designed as non-degree vocational programs designed to prepare individuals for gainful employment in essential occupations. *Exhibit 5*.

OIG's threatened action affects about 205 students and about 41 people employed as faculty and staff including the management. *Exhibit 4 ¶ 6*.

III. THE 85 PERCENT RULE

The 85 Percent Rule was enacted in 1992. It provided that proprietary institutions of higher education must derive "at least 15 percent" of their revenues from non-Title IV sources. Section 481(b)(6) of the HEA.

According to the Secretary, the principal purpose of the law "... is to require proprietary institutions to attract students based on the quality of their programs, not solely because the institutions offer Federal student financial assistance. Thus, under the statute, these institutions must attract students who will pay for their programs with funds other than Title

³ And, even assuming it was not in compliance for FY 1997, its maximum liability exposure would be one year, FY 1998, since it would have been able to return to Title IV participation in FY 1999 following the 1998 hiatus. 34 C.F.R. § 600.5(g).

APPENDIX I

IV, HEA program funds." *Exhibit 6*, 59 *Fed. Reg.* 6446, 6448 (Feb. 10, 1994)(emphasis added).

Final regulations were promulgated on April 29, 1994. *Exhibit 7*. Congress, however, delayed their effective date to July 1, 1995. Pub.L.103-333; see 34 C.F.R. § 600.5(a)(8). The regulations require all proprietary institutions to disclose the percentage of their revenue derived from Title IV, HEA programs, as defined at section 600.5(d), in a footnote to their annual audited financial statements. 34 C.F.R. § 668.23(d)(4).

The Secretary requires a proprietary institution to determine the percentage of its revenue from Title IV and non-Title IV sources by dividing the amount of Title IV funds the institution used to satisfy tuition, fees and other institutional charges by the sum of revenues generated by the institution from tuition, fees and other institutional charges for students enrolled in eligible programs as defined in 34 CFR § 668.8. See 34 C.F.R. § 600.5(d)(1).

IV.

CAPITOL CITY IS IN COMPLIANCE WITH THE 90 PERCENT RULE

Capitol City's 90/10 calculation for fiscal year 1998 is 84.5% *Exhibit 3 at note 13*. SBC audited the calculation and followed all known OIG interpretations governing cash basis accounting. Capitol City's fiscal year 1997 calculation complied with the 90 Percent Rule based on OIG calculations in the Draft Audit. *Exhibit 2 at note 13*. In fact, Capitol City meets the 90 Percent Rule without SEOG matching funds or institutional loan and third party loan revenue. *Exhibit 4 ¶ 9*.

While the 90 Percent Rule was not in effect for Fiscal Year 1997, Capitol City considers the fact that it met the new Rule in those years a relevant consideration especially given Congress' clear action modifying the rule to 90/10 since the 85 Percent Rule was too restrictive.

V.

CAPITOL CITY'S TREATMENT OF MATCHING FUNDS WAS CORRECT

OIG states that Capitol City improperly included \$24,209 in SEOG matching funds as non-Title IV revenue in FY 1997. *Exhibit 1 at 6*. Capitol City's treatment of these funds as non-Title IV revenue in the denominator of the fraction was proper.

For example, in the preamble to the final regulations, a commenter said that

"institutional portions of programs, such as the Federal SEOG and Federal Perkins programs, should not be included in the numerator since the

APPENDIX I

money comes from the institution and not the Federal Government.”
Exhibit 7 at 22327.

In response, the Secretary said

“The Secretary **agrees**. An institution should not include institutional matching funds in the numerator as part of its title IV, HEA funds.”
Id.

The Secretary clearly agreed that the matching funds are “money” from the school in specifically limiting the exclusion to the numerator! Capitol City and its accountants reasonably and properly interpreted this language to mean that matching funds could be included in the denominator of the fraction.

VI.

CAPITOL CITY’S CALCULATIONS SHOULD HAVE INCLUDED THE PRINCIPAL FROM INSTITUTIONAL AND THIRD PARTY LOANS

OIG did not question Capitol City’s institutional and third party loan revenue because Capitol City only included cash payments from student borrowers as revenue in the year in which the payments were received. While Capitol City and its accountants previously elected to limit revenue to student cash payments, Capitol City is entitled to count the entire principal amount of the loan made in the year in which it was made. *See Section VI at 5 – 7, infra. Exhibit 4.*

Capitol City made institutional loans to students during FY 1997 totaling about \$46,547.73. *Exhibit 18.* Of this amount, Capitol City received payments totaling about \$15,199.52 during FY 1997. *Exhibit 18.* The payments made during FY 1997 appeared in Note 13 to Capital City’s FY 1997 financial statements - the 85/15 calculation. *Exhibit 2.* However, the balance of the institutional loans originated and listed on student ledger accounts during FY 1997 totaled \$31,347.21 and was not contained in the calculation due to the extremely conservative approach taken by the school and its accountants. *Exhibits 2 and 4.*

In addition, a total of \$117,682.26 in third party loans were originated during FY 1997. *Exhibit 17.* Third party loan payments contained in the figures found in Note 13 to Capital City’s FY 1997 financial statements total \$67,155.58. *Exhibit 2.* That total (\$67,155.58) included payments received on loans that originated before FY 1997 as well as any payments from loans originated during FY 1997. The difference, \$50,526.68 (\$117,682.26 - \$67,155.58), represents third party loans that were not counted in the denominator of the School’s calculation found in Note 13 to its FY 1997 financial statements. *Exhibit 23.*

APPENDIX I

Therefore, a total of \$81,873.89 (\$31,347.21 + \$50,526.68) of revenue was not included in Capitol City's FY 1997 85/15 calculation. Inclusion of said amount allows Capitol City to comply with the 85 Percent Rule for FY 1997 with a percentage of 83.3, even allowing for the exclusion by OIG of \$84,429 relating to the sale of accounts. *Exhibit 4 & 23*. Of course, Capitol City justifies inclusion of the sale of the student accounts below.

The institutional and third-party loan revenue that was not captured in its FY 1997 85/15 calculation (\$81,873.89) is properly recognizable as non-Title IV revenue in the fiscal years in which the loans were made and documented by legitimate loan documents. As evidenced by the promissory notes (third party and institutional) and related documentation signed by students, Capitol City's students entered valid loan agreements enhancing Capitol City's assets (as required by FASB No. 6, discussed below). *Exhibits 17, 18, 19, 20, 21, 22, and 23*. OIG concludes that these amounts should not be counted as revenue because it does not consider the loan when made to be "revenue received" as defined in § 600.5(d)(2)(i). *Id.*

OIG reaches its conclusion based on a definition of revenue set forth in Financial Accounting Standards Board ("FASB"), Statement of Financial Accounting Concepts No. 6. Exhibit 8. The FASB Concept defines revenue as "inflows or other enhancements of assets" and "actual or expected cash inflows (or the equivalent)". *Id.*

Any analysis of this position starts with the relevant law. In this regard, a principal source of guidance is the preamble to the final regulations in which the Secretary said that

"an institution is not prohibited from including institutional charges that were paid by institutional scholarships and institutional loans as revenue in the denominator of the fraction...provided that the scholarships and loans are valid and not just part of a scheme to artificially inflate an institution's tuition and fee charges." 59 *Fed. Reg.* 22324 (April 29, 1994), *Exhibit 7*.

Institutions and accountants reviewing this language have frequently concluded, without qualification, that the above quoted statement clearly meant what it says, that is, that institutional loans could be treated as revenue in the denominator of the fraction. See *Exhibits 10, 12, and 13*. OIG focuses on the word "paid" in the above quoted statement to argue that the Secretary only meant to treat as revenue those payments made on the loan as an inflow of revenue or cash from a source external to the institution. In fact, the charges were recognized as paid. If not, the student would have been billed for the balance as soon as the tuition cost was incurred and due.

This argument is misplaced. Among other things, Statement of Financial Accounting Concepts ("SFAC") 6 is not intended to define the timing of

APPENDIX I

recognition of revenue. *Exhibit 14*. Cash basis is not a GAAP concept, as such, the source of authority to interpret the Secretary's regulation and comments is not SFAC 6 but rather the Secretary's own guidance, as limited as that may be. *Id.* Simply put, the Secretary's straight forward language means that if the loans are valid and not part of a scheme to artificially inflate tuition and fees, then they may be counted as revenue in the denominator of the fraction at the time that the loan is properly documented or posted to the student's account. Further, these loans represent "other enhancements of assets" as defined by SFAC 6. *Exhibit 14*.

Institutions and their accountants have also recognized, however, that the regulation and preamble were not a model of clarity. See e.g. *Exhibits 10 & 12* including one CPAs call to Ms. Leibovitz, the person designated by the Department in the final regulation as the point of contact for any questions involving the 85 Percent Rule. *Exhibit 12 at 1* and *Exhibit 7 at 22324*. Others such as Dr. Sharon Bob, a financial aid consultant, sought guidance and confirmation in writing. *Exhibit 10*.

On May 13, 1994, within two weeks after the final regulation was published, Dr. Sharon Bob, a well known financial aid consultant, wrote Ms. Leibovitz asking for confirmation that institutional loans could be treated as revenue in the denominator of the fraction in the year in which the loans were made. *Exhibit 10*. On August 24, 1994, about three months later, Ms. Leibovitz responded with countersignature evidencing her agreement with Dr. Bob's interpretation of the regulation on this point. The fact that it took Ms. Leibovitz three months to respond indicates that the affirmation was provided only after a deliberative and well reasoned consideration of the question.

At about the same time that Ms. Leibovitz was considering her response and without either party knowing about the other, Ms. Tostenrud called Ms. Leibovitz in early August to ask a series of questions about the Rule. *Exhibit 12*. All of Ms. Tostenrud's questions are attached to her letter. *Exhibit 12*. The second question on her list is whether the note receivable can be treated as a payment on the account in the year in which the institutional loan was made. Ms. Leibovitz directed Ms. Tostenrud to call Mr. Pat Howard of OIG to obtain answers to her questions.

On August 16, 1994, she spoke with Mr. Howard. *Id.* Mr. Howard's answer was "yes"; the amount of the loan could be treated as a payment on the account so long as the loan was a valid or real loan, exactly as Capitol City did. *Id.* Coincidentally or not, Ms. Leibovitz responded to Dr. Bob's letter within days after Ms. Tostenrud's conversation.

The letter countersigned by Ms. Leibovitz, Mr. Howard's response to Ms. Tostenrud and Capitol City's treatment of institutional loans are all fully consistent.

This information and, in particular, Dr. Bob's letter, were widely disseminated around the country and among proprietary institutions. See e.g. *Exhibit 13 at ¶ 12 (Declaration by Nancy Broff, General Counsel, Career College Association indicating that Leibovitz was the appropriate person to respond to this issue and that CCA widely disseminated the letter)*. Others such as Dr. Bob herself and this Firm widely disseminated it as well.

As noted in Dr. Bob's countersigned letter, the question was of profound importance to the proprietary sector, which was why she specifically wanted a countersignature. The letter could not answer the question any more clearly.

Capitol City's interpretation of the law is fully consistent with the regulation, the preamble to the regulation and the "supplementary" guidance issued by the Department and OIG. Its interpretation and application of this interpretation of the 85 Percent Rule were made in good faith reliance on all available evidence and instruction. *Exhibit 4*.

VII.
CAPITOL CITY'S SALE OF DELINQUENT STUDENT ACCOUNTS WAS A
LEGITIMATE TRANSACTION AND THE REVENUE FROM THE SALE
SHOULD BE INCLUDED IN ITS 85/15 CALCULATION

OIG takes the position that Capitol City's inclusion of \$84,429 of non-Title IV revenue in its 85/15 calculation is improper upon its conclusion that the revenue does not come from an independent source. *Exhibit 1 at 4*. However, the transaction resulting in the sale of the student accounts was a legitimate transaction that was made in good faith. *Exhibit 4*. In addition, the transaction was part of a planned effort to increase availability to and use of non-Title IV financing alternatives for the students at Capitol City. *Exhibit 4*.

Timberline I is a general partnership comprised of two corporate partners. Capitol City and Timberline I observed the benefits to the institution and its students if it could identify and cultivate alternative financing sources to Title IV and the third-party lenders. Traditional third-party lenders generally require relatively high interest rates due to a high rate-of-return requirement. While students clearly benefit from alternative financing sources, especially due to the possibility of lower interest rates than traditionally available, the School also benefits from the reduction of reliance on Title IV revenues. The goal is to have Timberline I provide an alternative source of financing. *Exhibit 4*.

As part of the plan, the parties expect to have to develop a 'track record' in order to make realistic allowances for uncollectible accounts and to enhance market value of such accounts to third parties investors. Timberline I discovered that no bank or investor would provide financing for Capitol City's students without demonstrable evidence of a favorable track record in this regard. Since it

APPENDIX I

could not obtain outside third party financing without a record of transactions, Timberline I was placed in the position of having to provide the financing. *Exhibits 4, 15, and 25.*

The figure Timberline I paid for the student accounts was reasonable and within market parameters. Timberline I consulted with Mr. Stephen B. Friedheim, II, a well known and respected business advisor in the area of proprietary institutions involved in Title IV prior to undertaking the transaction. Timberline I learned that, despite the fact that no other entities were involved in such transactions, it was reasonable to expect to collect between 60% and 80% of such student accounts with reasonable collection efforts. Given its confidence with respect to its ability to successfully collect the accounts, Timberline I determined that a reasonable purchase price was approximately 80% of the value of the student accounts. *Exhibits 4 and 25.* After it purchased the student accounts, Timberline I made good faith efforts to collect.⁴ Unfortunately, its collection efforts were not as successful as expected.⁵

In fact, had the collection efforts been entirely successful, Timberline I would have achieved a 25% return on its investment. Even allowing for bad accounts, it was reasonable to expect a return of 10%. *Exhibit 25.*

The transaction by which Timberline I acquired Capitol City student accounts was not a sham nor was it devised merely to allow Capitol City to comply with the 85/15 requirement. Nor is there any proscription on such a transaction within the context of Title IV. *Exhibit 25.* It was the first step in a reasoned business process intended to increase financing alternatives for students and prospective students. It was also a significant and long-term step to reducing the students' use of and reliance upon Title IV in order to achieve their academic and career goals. As such, the revenue derived from the sale is properly included in Capitol City's 85/15 calculation. *Exhibits 4 and 25.*

To the extent the price Timberline I paid for the student accounts is considered too high under the circumstances, it cannot lead to the conclusion

⁴ Timberline I believes that students are more likely to pay obligations to third party lenders as opposed to Capitol City. In addition, Timberline I wanted to avoid collateral effect upon students of Capitol City making collection efforts. Timberline I did not want students to blame Capitol City if Capitol City made the collection efforts. *Exhibit 4.*

⁵ Timberline I failed to achieve the necessary collection rate due, in large part, to the fact that it suffered some turnover of essential employees during that period which hampered its collection efforts. The loss of important personnel caused Timberline I to lose valuable time in its collection efforts. A continued delay would further erode the collection effort and it became apparent that the more prudent business tact was to use the services of a collection agency until such time as Timberline I could re-develop the personnel necessary to successfully manage collection of the accounts. *Exhibit 4.*

APPENDIX I

that all of the revenue derived by the sale should be excluded from Capitol City's 85/15 calculation. As stated by Mr. Friedheim in his declaration, Exhibit 25, a reasonable price for the accounts was somewhere between 60% and 80%. At 80%, the accounts are valued at \$84,429.00. At 60% they are valued at \$63,321.75. Therefore, the revenue used from the sale of student accounts should not be less than the 60% level or \$63,321.75. Adding at least the minimum figure (\$63,321.75) to the additional revenue identified in Section VI, above, ensures that Capitol City satisfies the 85/15 Rule for Fiscal Year 1997.

VIII. THE DEPARTMENT IS OBLIGATED TO APPLY ITS REGULATIONS UNIFORMLY

The Higher Education Act requires the Secretary to uniformly apply and enforce his regulations throughout the country. 20 U.S.C. § 1232 (c). See *Chula Vista City School Dist. V. Bennett*, 824 F.2d 1573, 1583 (Fed. Cir. 1987), cert. den., 484 U.S. 1042 (1988); *In the Matter of Blair Junior College*, Dkt. No. 93-23-SP (June 1, 1994)(Dec. of ALJ Cross) at 26 (Exhibit 23); *In the Matter of Nettleton Junior College*, Dkt. No. 93-29-SP (June 8, 1994)(Dec. of ALJ Cross)(Exhibit 23). This principle is embodied in the concept of equal protection of the law. Equal protection "is essentially a direction that all persons similarly situated should be treated alike." *City of Cleburne, Texas v. Cleburne Living Center*, 473 U.S. 432, 439 (1985).

Were the Department to accept the interpretation of the 85 Percent Rule and institutional charge definition now being advanced by OIG for 85/15 analysis to past years, it would violate the above-described fundamental principle since other similarly situated Colleges are not being treated alike.

IX. CAPITOL CITY IS ENTITLED TO RELY ON ITS CALCULATION SINCE IT WAS PERFORMED IN GOOD FAITH AND WITH NO GUIDANCE WITHOUT PENALTY OR THE THREAT OF PENALTY

Capitol City and its accountant calculated the 85/15 percentage in good faith and without adequate guidance from the Department or OIG. OIG does not question Capitol City's good faith. Good faith and reasonable interpretations of the law should be entitled to be made without threat of penalty, whether in terms of liabilities or eligibility.

X. CONCLUSION

Capitol City's 85/15 calculation for FY 1997, based on the arguments and adjustments discussed above and without including at least \$63,321.75 from the

APPENDIX I

sale of student accounts as discussed in Section VII, equals 83.3%. Of course, inclusion of the revenues from the sale of student accounts, even at the minimum level of 60% of the face value of the accounts, further ensures Capitol City's satisfaction of the 85/15 requirement for Fiscal Year 1997.

The evidence demonstrates that Capitol City's calculation was made in good faith and that the Institution is unquestionably in compliance with the 90 Percent Rule for fiscal years 1997 and 1998. Furthermore, Capitol City acted in reliance on the Department's limited guidance and, perhaps, misstatements. Capitol City also acted in reasonable reliance on its accountants and business consultants in calculating its 85/15 percentage and with respect to the contested transaction in which Timberline I purchased the student accounts. Finally, Capitol City has a long and consistently good Title IV compliance history such that it deserves reasonable consideration of the decisions it made under the circumstances described, above.

Capitol City respectfully submits that OIG should withdraw its conclusions and recommendations.

Respectfully submitted,


Peter S. Leyton, Esq.
Gerald M. Ritzert, Esq.
Ritzert & Leyton, P.C.
10387 Main Street, Suite 200
Fairfax, VA 22030
703-934-2660
Fax: 703-934-9840
pleyton@ritzert-leyton.com
gritzert@ritzert-leyton.com

Dated: August 27, 1999

TABLE OF CONTENTS

| | <u>Page</u> |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------|
| Part I: Preliminary Statement | 1 |
| Part II: Background | 2 |
| Part III: The 85 Percent Rule | 2 |
| Part IV: Capitol City Is In Compliance With The 90 Percent Rule | 3 |
| Part V: Capitol City's Treatment Of Matching Funds Was Correct | 3 |
| Part VI: Capitol City's Calculations Should Have Included The Principal From Institutional And Third Party Loans | 4 |
| Part VII: Capitol City's Sale Of Delinquent Student Accounts Was A Legitimate Transaction And The Revenue From The Sale Should Be Included In Its 85/15 Calculation | 7 |
| Part VIII: The Department Is Obligated To Apply Its Regulations Uniformly | 9 |
| Part IX: Capitol City Is Entitled To Rely On Its Calculation Since It Was Performed In Good Faith And With No Guidance Without Penalty Or The Threat Of Penalty | 9 |
| Part X: Conclusion | 9 |

APPENDIX I

EXHIBIT LIST Capitol City Trade & Technical School

1. OIG Draft Audit
2. Fiscal Year 1997 Financial Statements
3. Fiscal Year 1998 Financial Statements
4. Declaration of Robert C. Holt
5. Capitol City Trade & Technical School Catalog 1998-1999 (current)
6. Federal Register, February 10, 1994
7. Federal Register, April 29, 1994
8. Statements of Financial Accounting Concepts No. 6
9. OIG Dear Colleague Letter, CPA-99-01, April 26, 1999
10. Letter from Sharon Bob to Cheryl Leibovitz, May 13, 1994
11. Left Blank Intentionally
12. Letter from Chris Tostenrud to Peter S. Leyton, dated June 1, 1999
13. Declaration of Nancy Broff, General Counsel to Career College Association
14. CON 6: Elements of Financial Statements- FASB
15. Agreements to Purchase Student Accounts
16. FY 1997 Capitol City Trade & Technical School 85/15 Combined Report
17. FY 1997 List of students originating third party loans
18. FY 1997 List of students originating institutional loans
19. Sample Student Ledger
20. Sample Student Promissory Note, Enrollment Agreement, and related financial aid information
21. Sample Third Party Installment Note and Disclosure Statement

APPENDIX I

22. Sample Third Party Lender Agreement between Capitol City Trade & Technical School

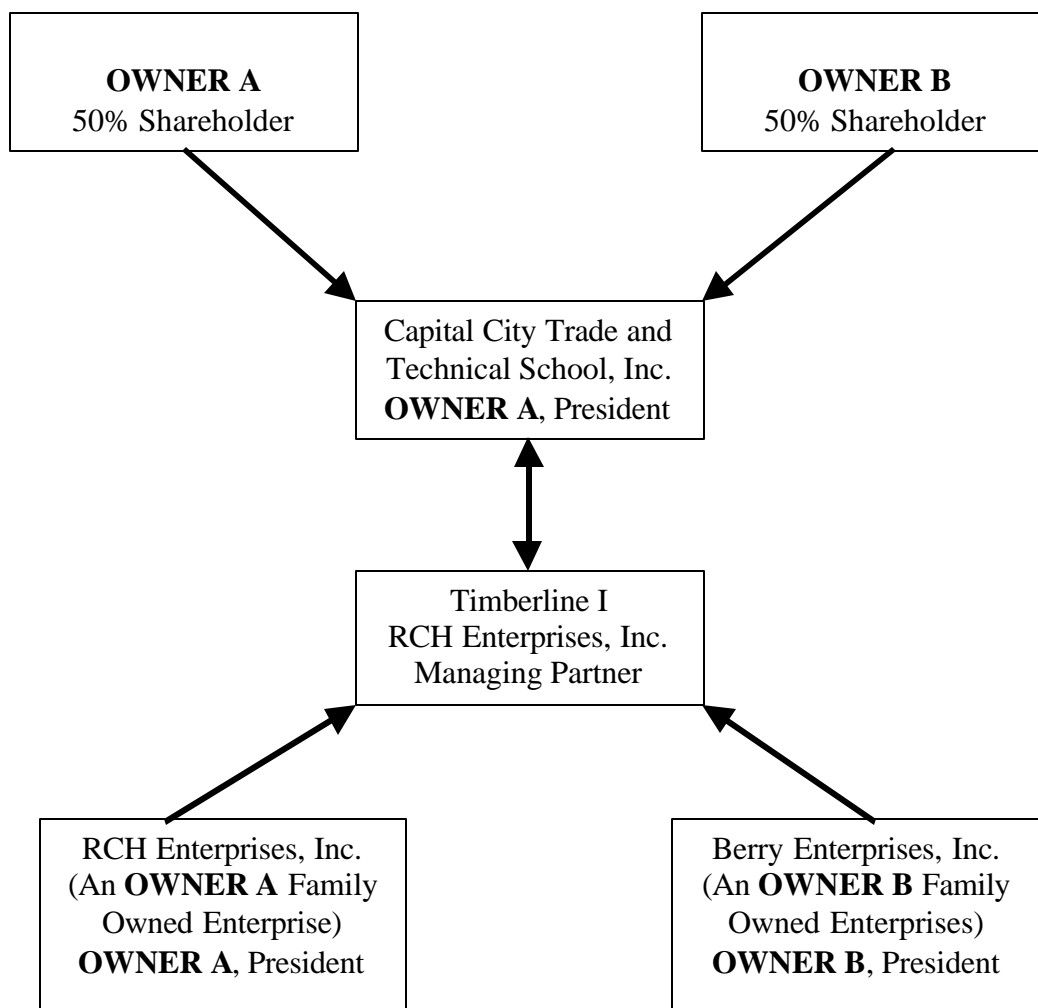
23. Declaration of Larresia C. Loyd – Director of Financial Aid

24. Decisions in the matters of Blair Junior College and Nettleton Junior College

25. Declaration of Stephen B. Friedheim, II

The below chart illustrates the relationships between the various organizations that were involved in the December 1997 transactions.

ORGANIZATION RELATIONSHIPS



DISTRIBUTION SCHEDULE
Audit Control Number: ED-OIG/A06-80008

| | <u>Copies</u> |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------|
| Auditee | 1 |
| Action Official | |
| Greg Woods, Chief Operating Officer Student Financial Assistance Department of Education ROB-3, Room 4004 7th and D Streets, SW Washington, DC 20202-5132 | 1 |
| Other ED Offices | |
| General Manager for Schools Channel, Student Financial Assistance | 1 |
| Chief Financial Officer, Student Financial Assistance | 1 |
| Director, Case Management & Oversight, Schools Channel, Student Financial Assistance | 1 |
| Area Case Director, Dallas Case Management Team, Case Management & Oversight, Schools Channel, Student Financial Assistance | 1 |
| General Counsel, Office of the General Counsel | 1 |
| OIG | |
| Inspector General | 1 |
| Deputy Inspector General | 1 |
| Assistant Inspector General for Investigation (A) | 1 |
| Assistant Inspector General for Audit | 1 |
| Deputy Assistant Inspector General for Audit | 1 |
| Director, Student Financial Assistance Advisory and Assistance Team | 1 |
| Regional Audit Offices | 6 |
| Dallas Audit Office | 6 |