



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

NOV 1 1999

CPA-99-02

Dear Certified Public Accountant:

On April 26, 1999, we issued Dear Certified Public Accountant Letter CPA-99-01. In that letter we provided guidance to practitioners performing financial statement audits of proprietary institutions on the 85/15 now 90/10 percent revenue test. The effective date for the 90/10 percent revenue test was October 1, 1998. Our letter stressed that the amounts to be included as revenue in the calculation were only those amounts measured using the cash basis of accounting.

The Department recently issued a Dear Partner Letter GEN-99-33 informing the education community of the enforcement policy it expects to follow with respect to institutional loans and scholarships between now and when the Department's new regulations go into effect on July 1, 2000. Specifically, the Department advised the education community that with respect to valid institutional loans and scholarships, the Department, absent unusual circumstances, did not intend to exercise its enforcement authority against institutions that rely on these loans and scholarships as non-federal revenue solely on the grounds that the loans and scholarships fail to comply with cash basis accounting requirements. See attachment 1 for the Dear Partner Letter.

This letter provides guidance for practitioners on how to evaluate institutional loans and institutional scholarships on other than the cash basis of accounting as a result of the Dear Partner Letter. All other guidance in Dear Certified Public Accountant Letter CPA-99-01 is still in force. Apart from valid institutional loans and valid institutional scholarships, all revenue amounts used in the calculation are measured solely on the cash basis of accounting.

Interim Disclosure Requirement

The Department has stated that, for institutions submitting their financial statements prior to July 1, 2000, it does not expect to use its enforcement authority, absent unusual circumstances, against institutions using valid institutional loans and institutional scholarships solely on the grounds that the loans and scholarships do not comply with cash basis accounting requirements. Institutions not using the cash basis of accounting for institutional loans or institutional scholarships must report two different percentages. The calculation for these two percentages must be provided for any period that the institution does not use the cash basis of accounting for institutional loans or scholarships.

The first percentage should include in the denominator the amount of institutional loans or institutional scholarships applied to the student accounts during the fiscal year that the auditor has accepted as valid under these guidelines. Only those amounts that conform to the presumption that Title IV is applied first to tuition, fees, and other institutional charges may be included in the calculation. The second percentage should include in the denominator only those amounts from institutional loans and institutional scholarships that can be measured as revenue using the cash basis of accounting. In addition, the footnote disclosure must also show the amounts used in both calculations. If an institution chooses to use the cash basis of accounting for institutional loans and institutional scholarships, only that one percentage needs to be reported.

To increase audit efficiency, we recommend that practitioners first determine whether the institution would meet the requirement using the cash basis of accounting for both institutional loans and scholarships. If the institution meets the requirement using the cash basis of accounting, the institution would report that percentage and the practitioner should use the guidance in Dear Certified Public Accountant Letter CPA-99-01. If the institution does not meet the requirement using the cash basis of accounting and computed its calculation using other than the cash basis of accounting, the practitioner must follow the guidance below to determine whether the institutional loans and scholarships were valid. The non-cash basis calculation may include only valid institutional loans and scholarships. As stated above, if other than the cash basis of accounting is used for institutional loans and scholarships, two percentages must be reported.

Institutional Loans

The Department has stated that “the facts must show that students routinely repay institutional loans.” In addition, the loans must be “valid and not part of a scheme to artificially inflate an institution’s charges.” Practitioners should note only those amounts from valid institutional loans that are actually applied to student accounts can be counted in the calculation.

In evaluating institutional loans, practitioners will need to use professional judgment in determining the audit steps necessary to reach a conclusion on the validity of institutional loans. In our opinion, in evaluating the validity of institutional loans, the practitioner should, among other steps deemed appropriate:

- Determine whether the institutional loans are supported by enforceable promissory notes.
- Evaluate whether the institutional loans are routinely repaid. As an indication that institutional loans might not be valid, we believe that a fair basis for comparison on whether institutional loans are routinely repaid is whether the default rate on institutional loans exceeds 15 percent. This percentage for defaulted loan collections corresponds to the administrative capability threshold for institutions that participate in the Federal Perkins Loan program, 34 CFR Section 668.16m(1)(ii). In addition, the practitioner should evaluate the allowance for doubtful accounts in determining

whether the loans are routinely repaid. Even in cases where the loans appear to be routinely repaid, the practitioner should determine whether there is evidence of actual attempts at collection or enforcement of the promissory notes for non-performing loans.

- Evaluate the timing of the institutional loans. An indication that institutional loans may not be valid would be, for example, where the majority of institutional loans are made at the end of an institution's fiscal year rather than at recurring intervals that are related to an institution's enrollment cycle. In general, institutional loans would typically be made around the time a student begins an academic year or new period of enrollment.

Institutional Scholarships

The Department has stated that institutional scholarships "will only be valid if a substantial number of the comparable students are paying the stated institutional charges without receiving institutional scholarships, and the scholarships do not otherwise appear to be artificial transactions."

In evaluating institutional scholarships, practitioners will need to use professional judgment in determining the audit steps necessary to come to a conclusion on their validity. In our opinion, in evaluating the validity of institutional scholarships, the practitioner should, among other steps deemed appropriate:

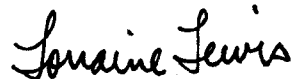
- Determine whether a substantial number of students in the same eligible program at the institution are paying the stated institutional charges without receiving institutional scholarships.
- Evaluate the timing of institutional scholarships. An indication that institutional scholarships may not be valid would be if the majority of institutional scholarships are made at the end of an institution's fiscal year rather than at recurring intervals that are related to an institution's enrollment cycle. Another indication that the institutional scholarships may not be valid would be if the scholarships are awarded after students drop out owing the institution money.
- Determine whether students know that they were awarded scholarships and whether the students applied for the scholarships.
- Evaluate the criteria used for awarding institutional scholarships in making a judgment on the validity of the institutional scholarships. Criteria that can be manipulated may be an indication of invalid institutional scholarships. An example of an invalid criterion would be where the institution sets an academic standard for scholarships but allows management to lower the standard at its discretion.
- Determine whether the criteria for awarding institutional scholarships are consistently followed.

- Determine whether information regarding scholarships is generally made known to students, in its catalog, publications, or notices made available to students.
- Ensure that the amount of institutional scholarships included in the calculation corresponds to actual adjustments for institutional scholarships in the income statement. If the institution does not recognize the institutional scholarships for financial statement or tax purposes, they should not be recognized for purposes of the calculation.

Working Papers

In those cases in which the institution is required to report two percentages (one on the cash basis of accounting and one based on guidance in the Dear Partner Letter), the practitioners working papers must clearly document that an evaluation of the validity of institutional loans and scholarships was made.

Sincerely,

A handwritten signature in black ink that reads "Lorraine Lewis". The signature is written in a cursive style with a large initial "L".

Lorraine Lewis

Attachment



UNITED STATES DEPARTMENT OF EDUCATION

WASHINGTON, D.C. 20202-_____

October 1999

GEN-99-33

SUMMARY: This letter announces standards that will be used to review 85/15 and 90/10 eligibility calculations for proprietary schools that include institutional scholarships and loans as revenue.

Dear Partner:

During the recent negotiated rulemaking meetings to develop proposed regulations under the Higher Education Act (HEA) it became apparent that there have been some differing interpretations within the higher education community of the standards used to determine whether institutional scholarships and loans may be included in a proprietary school's 85/15 eligibility calculation. As a result, we are providing this policy guidance that will remain in effect until the final regulations for the changed 90/10 HEA requirements go into effect on July 1, 2000.

The preamble for the 85/15 regulations published in April 1994 established a general requirement that both the numerator and denominator of the 85/15 fraction be reported for the institution's fiscal year using a "cash basis of accounting [where] the institution reports revenues on the date that the revenues are actually received." 59 FR 22328. The preamble also explained that institutional scholarships and loans could only be treated as revenue in the eligibility calculation if they were valid and not part of a scheme to artificially inflate an institution's charges. If institutional loans are provided, the facts must show that the students routinely repay the loans. 59 FR 22328. Institutions have commented that these specific guidelines for institutional loans and scholarships were understood by some to supersede the general requirement that all funds in the 85/15 calculation must be revenue under a cash basis of accounting, and have requested additional guidance on this point.

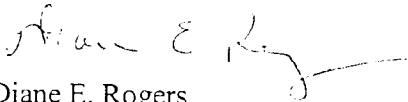
Until the new regulations for measuring 90/10 eligibility calculations go into effect on July 1, 2000, the Department will use the following process for determining whether institutional loans and scholarships may be counted as revenue in an 85/15 or 90/10 eligibility calculation. The Department will continue to examine institutions closely to determine whether the institutional loans and scholarships are valid, particularly where a substantial amount of revenue is attributed to institutional loans and institutional scholarships. Institutional loans will only be valid if the students routinely repay them and they do not otherwise appear to be part of a scheme to artificially inflate an institution's tuition and fee charges. Institutional scholarships will only be valid for this purpose if a substantial number of the comparable students at the institution are paying the stated institutional charges without receiving scholarships, and the scholarships do not otherwise appear to be artificial transactions.

The Department will exclude institutional loans and scholarships from being treated as revenue in an 85/15 or 90/10 calculation when they are not valid under this analysis. Institutional loans and scholarships that fail this validity test may also be challenged on the basis that they do not constitute revenue under a cash basis of accounting. As to loans and scholarships that are determined to be valid under this analysis, the Department, absent unusual circumstances, does not intend to exercise its enforcement authority against institutions that count these loans and scholarships as revenue solely on the grounds that the loans and scholarships fail to comply with cash basis accounting requirements.

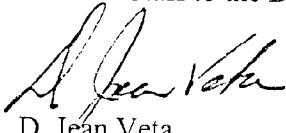
We believe that this enforcement policy, which is expected to remain in effect until the new regulation's effective date of July 1, 2000, provides institutions with a reasonable opportunity to demonstrate compliance with the requirements during prior fiscal years. The enforcement policy will apply to school audits and 85/15 or 90/10 eligibility calculations that are submitted to the Department before July 1, 2000. This policy will also provide ample time for institutions to ensure that they will be in compliance with the new regulations that will go into effect on July 1, 2000, including the requirement that all institutional loans and scholarships comply fully with the cash basis of accounting.

If you have any questions about this letter, please contact Keith Kistler in the Performance Improvement and Procedures Division at (202) 260-5742.

Sincerely,



Diane E. Rogers
Chief of Staff to the Deputy Secretary



D. Jean Veta
Deputy General Counsel