

The attached April 26, 1999 Dear Certified Public Accountant (CPA-99-01) letter supplements guidance in the July 1997 SFA Audit Guide on the 85/15 (now 90/10) revenue test. The letter does not require practitioners to submit any additional reports. We are in the process of updating the SFA Audit Guide and expect: (1) to have that Guide available in June, and (2) to clarify the reporting process on the 90/10 revenue test.

April 26, 1999

Dear Certified Public Accountant:

Practitioners performing financial statement audits of proprietary institutions in accordance with the July 1997 updated Audit Guide, *Compliance Audits (Attestation Engagements) of Federal Student Financial Assistance Programs at Participating Institutions*, must ascertain the validity of the institution's 85/15 percent revenue calculation¹. The Audit Guide refers to the calculation as the 85/15 revenue test. The 85/15 revenue test determines an institution's compliance with the requirement that no more than 85 percent of the institution's revenues for tuition, fees and other institutional charges to students in eligible programs are derived from Title IV Student Financial Aid programs.

The U. S. Department of Education, Office of the Inspector General (ED/OIG) has identified mistakes in the calculation of the 85/15 percent revenue test in audited financial statements submitted to ED which indicated that the institutions met the revenue requirement when they had not. While, as noted above as footnote 1, proprietary institutions will after October 7, 1998 be subject to a 90/10 revenue test, the same calculation principles apply. Therefore, the guidance in this letter applies equally to audits of the 90/10 revenue test applicable in future years. This letter addresses some of the mistakes and gives guidance to the CPA community auditing the 85/15 percent revenue test. Specific examples of mistakes were: (1) institutional scholarships being counted as revenue and (2) failure to account for institutional loans and other amounts on a cash basis when counting them toward non-Title IV revenue.

Because the 85/15 revenue test is a critical determination affecting the institution's continued eligibility, it is important that practitioners examine the underlying information supporting the footnote disclosures and perform the necessary procedures to satisfy the applicable auditing standards. Audits found to be substandard relating to the 85/15 revenue test may result in rejection and referral of the CPA to the American Institute of Certified Public Accountants and the appropriate State licensing board for disciplinary actions. In addition, practitioners who are referred may be subject to suspension and debarment from Federal programs and/or civil actions.

Background

¹ This provision was contained in HEA Section 481(b)(6). The 1998 Amendments to the HEA that were enacted on October 7, 1998 changed this provision to require that after that date a proprietary institution have at least 10 percent of revenue from non-Title IV sources. Therefore, 85/15 is now 90/10.

The Higher Education Act of 1965, as amended, (HEA) requires all institutions to obtain annual financial and compliance audits of their participation in the Title IV HEA programs. The financial statements must be prepared in accordance with generally accepted accounting principles and audited in accordance with the standards for financial audits of the U. S. General Accounting Office's *Government Auditing Standards (GAS)*, issued by the Comptroller General of the United States. Regulations require that procedures for conducting the audits be available in audit guidance developed and issued by ED/OIG.

The July 1997 Audit Guide, *Compliance Audits (Attestation Engagements) of Federal Student Financial Assistance Programs at Participating Institutions*, states that the 85/15 revenue test is to be a footnote to the financial statements and instructs CPAs that the calculation is on a *cash basis* and must be computed in accordance with 34 CFR 600.5.

Scholarships and Institutional Loans

The preamble to the regulations, Federal Register/Vol. 59, No. 82/Friday, April 29, 1994, states that institutional scholarships and loans may be included in the revenue test but also clearly states that all revenue must be accounted for on the cash basis in order to meet the definition of revenue. (See Enclosure) Thus, current regulations require that scholarships and loans included as revenue to the school must result in an actual inflow of cash to the institution.²

Working Papers

The CPA is expected to determine whether the 85/15 percent calculation is fairly stated in all material respects and have adequate evidence in the working papers to support his/her conclusion. Government Auditing Standards, Paragraphs 4.34 through 4.37 require that working papers contain sufficient information to support the CPA's significant conclusions and judgments, of which the 85/15 calculation is one. AU 326.23 discusses the evaluation of evidential matter by the CPA.

Working papers must support the CPA's determination that the 85/15 calculation was made using the cash basis of accounting, that only cash revenues from eligible programs and locations are included in the calculation, and that the presumption of Title IV funds being applied to tuition and fees first is used. The CPA is expected to evaluate management's financial statement assertions against specific criteria. The criteria for evaluating management's assertions are found at 34 CFR 600.5 (a) and (d).

CPAs should be aware that materiality for 85/15 rule has a different threshold than the basic financial statement assertions because failure to meet 85/15 makes the institution completely ineligible to participate in Title IV programs. For example, a small error in accounting for cash could be immaterial to the financial statements taken as a whole, but could be the difference between meeting or not meeting the 85/15 requirement.

² The 85/15 revenue calculation rules are part of the current negotiated rulemaking process. Until such time as new regulations are finally adopted, current calculation rules as outlined here are in force.

Quality Control Reviews

CPAs should be aware that the financial statement audits are subject to quality control review (QCR) by ED/OIG. QCRs of working papers supporting audited financial statements which reveal serious deficiencies in a CPA's audit work that results in the Department of Education relying on the institution passing the 85/15 revenue test when it did not, may result in:

- rejection of the financial statement audit;
- referral of the CPA to the American Institute of Certified Public Accountants and appropriate State licensing boards for any disciplinary actions they might impose;
- suspension and debarment of the CPA from Federal government programs; and/or
- civil actions against the CPA.

In addition, the Office of Student Financial Assistance Programs, Institutional Participation and Oversight Service may itself reject financial statement audits that are substandard.

Questions pertaining to this letter may be directed to Jim Burley in the Dallas Office at 214 880-3031 or may be faxed to 214 880-2492.

Sincerely,

Robert G. Seabrooks
Acting Assistant Inspector General
for Audit

Enclosure

Requirements

The 1992 reauthorization of the HEA added a provision to the Act requiring that a proprietary institution (Federal Register/Vol. 59, No. 82/Friday, April 29, 1994):

“...has at least 15 percent of its revenues from sources that are not derived from funds provided under this title, as determined in accordance with regulations prescribed by the Secretary.”¹

Federal regulations were issued that prescribe the formula for calculating the percentage. Title 34, Code of Federal Regulations (CFR) Section 600.5(d)(2)(i) specifies 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.”

In the Preamble to the Final Rule, the Secretary clarified that:

“...since institutions must report and account for title IV, HEA program funds on a cash basis, the institution must also account for revenue in the denominator on a cash basis. Under a cash-basis of accounting the institution reports revenues on the date that the revenues are actually received.”

The Financial Accounting Standards Board (FASB) defines revenue in its Statement of Financial Accounting Concepts No. 6 as:

“...inflows or other enhancement of assets of a entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.”

Therefore, since revenues must be reported on a cash basis, the revenue that would be recognized for the 85/15 percent calculation must only be those revenues that result in an actual inflow of cash (revenue received).

¹ This provision was contained in HEA Section 481(b)(6). The 1998 Amendments to the HEA that were enacted on October 7, 1998 changed this provision to require that after that date a proprietary institution have at least 10 percent of revenue from non-Title IV sources. Therefore, 85/15 is now 90/10.

Further, 34 CFR 600.5(d)(1) is clear that only revenue from eligible programs can be included in the 85/15 percentage calculation:

*“...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**.”(emphasis added)*

Requirements for eligible programs are listed in 34 CFR 668.8. Eligible programs can only be offered at eligible Title IV locations [34 CFR 600.10(b)].

Also, for the purposes of the calculation, institutions must presume that title IV funds are used to pay institutional charges. Title 34 CFR Section 600.5(d)(2)(v) states that:

“...any title IV, HEA program funds disbursed to or on behalf of a student shall be presumed to be used to pay the student’s tuition, fees, or other institutional charges, regardless of whether the institution credits those funds to the student’s account or pays those funds directly to the student....”